DEMAND-SIDE GATEKEEPERS IN THE MARKET FOR HOME LOANS

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I. INTRODUCTION

The market for home loans has changed dramatically over the past thirty years, due, in large part, to the development of a market for asset-backed securities.[1] Encouraged through the creation of Fannie Mae and Freddie Mac—government-sponsored entities created to purchase and package small-to-medium-sized "conforming" mortgages—that effort had appeared until recently to be a success.[2] A robust market for real estate mortgage-backed securities ("RMBS") formed and then expanded well beyond the market for "prime" "conforming" mortgages that could be handled by Fannie and Freddie.[3] The development of a secondary market for both conforming and nonconforming home loans increased the availability of mortgage credit to consumers with lower income levels and with worse credit histories than ever before.[4] But, as recent events have demonstrated, this increased liquidity came at a high price.

The current crisis in the financial services sector demonstrates that this development of a secondary market for home loans produced unintended

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1. *See generally* DAN IMMERGLUCK, FORECLOSED: HIGH-RISK LENDING, DEREGULATION, AND THE UNDERMINING OF AMERICA'S MORTGAGE MARKET (2009); MICHAEL LEWIS, LIAR'S POKER (1989).

2. *See generally* David Reiss, *The Federal Government's Implied Guarantee of Fannie Mae and Freddie Mac's Obligations: Uncle Sam Will Pick Up the Tab*, 42 GA. L. REV. 1019 (2008).

3. For an overview of the development of Fannie Mae and Freddie Mac and their relationship to the creation of a secondary market for home loans, see, for example, Richard Scott Carnell, *Handling the Failure of a Government-Sponsored Enterprise*, 80 WASH. L. REV. 565, 570–96 (2005); Reiss, *supra* note 2, at 1027–34; Jason T. Strickland, Note, *The Proposed Regulatory Changes to Fannie Mae and Freddie Mac: An Analysis*, 8 N.C. BANKING INST. 267, 270–74 (2004).

4. Subprime and nonprime mortgages are loosely defined as residential mortgages that do not conform to the criteria for "prime" mortgages. Subprime mortgage holders have lower credit scores (usually 650 or below), spottier credit histories, and higher debt-to-income ("DTI") and mortgage loan-to-value ("LTV") ratios (DTI above fifty-five percent and LTV over eighty-five percent). Nonprime mortgage holders may not have credit scores below 650, but otherwise involve nonconforming borrowers; for example, borrowers who cannot substantiate their income because they are self-employed. These nonconforming mortgages are also referred to as "AltA" mortgages. *See generally* John Kiff & Paul Mills, *Money for Nothing and Checks for Free: Recent Developments in U.S. Subprime Mortgage Markets* (Int'l Monetary Fund, Working Paper WP/07/188, 2007), *available at* http://www.imf.org/external/pubs/ft/wp/2007/ wp 07188.pdf.

consequences for banks, consumers, and the real estate market. The story of the development of this market appears to be a story of clever transactional innovations taken two steps too far. Conflicts of interest and gatekeeper failures on the supply side led to overlending. But errors in consumer decision making and the absence of demand-side institutions to protect consumers also led to overborrowing.[5] Together they multiplied the level of risk in the banking system and helped provoke the subprime mortgage crisis.

In this Article we retell the story of how agency problems in the market for securitized home loans pumped up the level of risk in the financial system, and the related story of how these innovations encouraged overleverage. The shift to capital markets financing for home mortgages turned lenders into aggressive marketers of home loans and created a need for both consumer protection and consumer education—not just to protect consumers, but also to protect the integrity of the capital markets themselves.

The flourishing of the RMBS market coincided with, and spurred, a shift from relationship lending to capital markets financing of home mortgages.[6] This shift from a "face-to-face" model of mortgage underwriting to a "capital markets" model interposed a functional distance between the investor and the investment.[7] Instead of particularized investment decisions, capital markets investors came to rely on a series of "gatekeepers," such as credit reporting agencies, appraisers, and rating agencies, to protect the integrity of the market for mortgage-backed securities.[8] These gatekeepers were not new. Mortgage lenders had relied on appraisers long before anybody ever thought of securitizing mortgages.[9] The mortgage-backed securities market, however, changed the roles of these familiar gatekeepers in two crucial respects: (1) gatekeepers in the market for mortgage-backed securities are

5. See *infra* Part II.B for a discussion of the implications of poor consumer decision making and lack of protection from demand-side institutions.

6. *See generally* LEWIS, *supra* note 1.

7. *See* Kiff & Mills, *supra* note 4, at 11 ("The originate-to-distribute model is driven by fee generation, facilitated by risk dispersion and compartmentalization.").

8. *See, e.g.*, Claire A. Hill, *Securitization: A Low-Cost Sweetener for Lemons*, 74 WASH. U. L.Q. 1061, 1071–72 (1996) (discussing role of rating agencies); Steven L. Schwarcz, *Protecting Financial Markets: Lessons from the Subprime Mortgage Meltdown*, 93 MINN. L. REV. 373, 381 (2008) (indicating that capital market investors overrelied on third parties to make investment decisions). Reliance on gatekeepers to police the accuracy of information provided to capital markets is not unique to mortgage-backed securities. Indeed, the bulk of this literature looks to "gatekeepers" in the market for equity securities—auditors, lawyers, securities analysts, and credit rating agencies. *See generally* JOHN C. COFFEE JR., GATEKEEPERS: THE PROFESSIONS AND CORPORATE GOVERNANCE (2006); Lawrence A. Cunningham, *Beyond Liability: Rewarding Effective Gatekeepers*, 92 MINN. L. REV. 323 (2007); Merritt B. Fox, *Gatekeeper Failures: Why Important, What to Do,* 106 MICH. L. REV. 1089 (2008) (reviewing COFFEE, *supra*); Sean J. Griffith, *Uncovering a Gatekeeper: Why the SEC Should Mandate Disclosure of Details Concerning Directors' and Officers' Liability Insurance Policies*, 154 U. PA. L. REV. 1147 (2006); Assaf Hamdani, *Gatekeeper Liability*, 77 S. CAL. L. REV. 53 (2003).

9. Similarly, credit card issuers and other consumer lenders have long looked to credit reporting agencies to ascertain the creditworthiness of a particular borrower. Securities underwriters have long relied on rating agencies to ascertain the riskiness of the issuance of particular securities by a securities issuer. For extensive discussions of credit rating agencies, see, for example, RATINGS, RATING AGENCIES AND THE GLOBAL FINANCIAL SYSTEM 41–63 (Richard M. Levich et al. eds., 2002); TIMOTHY J. SINCLAIR, THE NEW MASTERS OF CAPITAL: AMERICAN BOND RATING AGENCIES AND THE POLITICS OF CREDITWORTHINESS 72–92 (2005).

relied upon to provide assurances about assets backed by consumer rather than corporate debt;[10] and (2) because these debt securities are backed by mortgage transactions, there are two "gates" to watch—the underwriting of the underlying mortgage itself and the later underwriting of the securities to the capital markets.[11]

This shift disturbed the historic identity of interests between mortgage originator and mortgage investor.[12] Historically, the originator and the investor were, in fact, one and the same. When mortgages are securitized, however, the originating bank does not hold the mortgage as an investment for its own portfolio, but instead sells it. As a result, profit maximization strategies shift.[13] Instead of investing, mortgage brokers sell a product. Appraisers and rating agencies have little stake in the outcome of the transactions they rate. They face only the risk of reputational sanctions if securitized loans go bad. But, since their customer is the broker, not the ultimate investor, the effect of reputational sanctions is further attenuated. At least in theory, the market should have picked up on these inherent agency problems and refused to purchase at least some mortgage-backed securities. Apparently, however, the market participants continued to rely on the rating agencies' risk assessments. What followed should not have been surprising. If the riskiness of a mortgage-backed security is not fully disclosed, investors will pay too much and consumer credit will be too cheap and too plentiful.

If borrowers were perfectly rational, one would have expected a consumer's own concerns about unsustainable debt to buffer the effect of supply-side gatekeeper failures, and the consequences of these failures would have been tolerable. Behavioral decision research generally suggests, however, that consumers have a predisposition to borrow more and pay more for credit than

10. *Cf.* John C. Coffee, Jr., *Can Lawyers Wear Blinders? Gatekeepers and Third-Party Opinions*, 84 TEX. L. REV. 59 (2005) (focusing on role and obligations of lawyers as gatekeepers).

11. Because most gatekeeping literature relates to gatekeepers in the market for equity securities, definitions of "gatekeepers" are often limited to this context. For example, in his recent book on the desirability of gatekeeper liability for corporate governance, John C. Coffee, Jr. defines gatekeepers narrowly and functionally as a "reputational intermediary to assure investors as to the quality of the 'signal' sent by the corporate issuer" of equity securities. COFFEE, *supra* note 8, at 2. But the term "gatekeeper" need not be defined so narrowly. When used outside the capital-market context, commentators tend to define the term more broadly. *See* Hamdani, *supra* note 8, at 63–65 (defining "gatekeepers" as actors who "offer a service or sell a product that is necessary for clients wishing to enter a particular market or engage in certain activities" and who "price their services to recover their marginal cost of providing the service and their expected liability" for clients' wrongdoing); Reinier H. Kraakman, *Gatekeepers: The Anatomy of a Third-Party Enforcement Strategy*, J.L. ECON. & ORG., Spring 1986, at 53, 53 (describing gatekeeper liability as genre of third-party liability used to supplement "efforts to deter primary wrongdoers directly by enlisting their associates and market contacts as de facto 'cops on the beat'").

12. *See* ADAM B. ASHCRAFT & TIL SCHUERMANN, FED. RESERVE BANK OF N.Y., STAFF REPORTS NO. 318, UNDERSTANDING THE SECURITIZATION OF SUBPRIME MORTGAGE CREDIT 3–11 (2008), *available at* http://www.newyork fed.org/research/staff_reports/sr318.pdf (discussing "seven key frictions" in securitization of subprime mortgage credit); Kiff & Mills, *supra* note 4, at 11 (stating that fee generation from loan origination to funding creates conflict of interest).

13. *See* Steven L. Schwarcz, *The Future of Securitization*, 41 CONN. L. REV. 1313, 1318–22 (2009) (attributing lowered investing standards to originate-to-distribute model of mortgage lending).

perfectly rational individuals.[14] As a result, problems on the supply side of the market for mortgage-backed securities also created problems on the demand side of the market for home loans.[15] In a world of strict mortgage underwriting and risk-averse lenders, originators would not let consumers borrow more than they could be expected to repay. In a world that separates the decision to originate a mortgage from the decision to hold a mortgage as an investment, demand-side irrationality[16] exacerbated the risks created by an imperfect system of supply-side gatekeepers. And this synergy of gatekeeper failure and consumer irrationality had systemic consequences. Systemic risk increased because of the greater risk of default. Enhanced default risk also added risk to collateral values. Not only did consumers find themselves with too much debt, but their exuberance pumped up a housing bubble.

In short, with twenty-twenty hindsight, consumer protection might have served to increase the safety and soundness of the financial system by preventing consumer overleverage. If lenders face incentives to overlend, and borrowers are hard-wired to overborrow, there is a need for both consumer protection law and regulation of the capital markets.[17] Indeed, as we will discuss later, even if all of the irrationality could be squeezed out of the supply side, consumer irrationality would still create policy-relevant social welfare costs. In our view, these demand-side institutions need to be strengthened in order to enhance social welfare, but also to enhance the safety and soundness of the financial system.

In Part II of this Article, we identify market failures both on the supply side and the demand side of the home mortgage market. On the supply side, the problem lies in imperfect incentive structures for the various supply-side gatekeepers. On the demand side, our concerns lie principally in the cognitive biases of consumer borrowers and the absence of demand-side institutions to either constrain or debias consumer choice.

In Part III, we explain why shifts in the nature of mortgage finance led to a greater need for consumer protection. We examine various demand-side gatekeeping institutions, exploring their interrelationships, as well as their relative strengths and weaknesses. As noted above, supply-side gatekeepers face, as of yet, unchecked incentives to maximize the amount of lending without also looking to minimize consumers' risk of default. Gatekeepers on the demand side generally do not face the same conflicts. However, we identify a different set of

14. *See generally* Oren Bar-Gill, *The Behavioral Economics of Consumer Contracts*, 92 MINN. L. REV. 749 (2008); Oren Bar-Gill, *Bundling and Consumer Misperception*, 73 U. CHI. L. REV. 33 (2006); Oren Bar-Gill, *The Law, Economics and Psychology of Subprime Mortgage Contracts*, 94 CORNELL L. REV. 1073 (2009) [hereinafter Bar-Gill, *Subprime Mortgage Contracts*]; Oren Bar-Gill, *Seduction by Plastic*, 98 NW. U. L. REV. 1373 (2004) [hereinafter Bar-Gill, *Seduction by Plastic*]; Oren Bar-Gill & Elizabeth Warren, *Making Credit Safer*, 157 U. PA. L. REV. 1 (2008); Susan Block-Lieb & Edward J. Janger, *The Myth of the Rational Borrower: Rationality, Behavioralism, and the Misguided "Reform" of Bankruptcy Law,* 84 TEX. L. REV. 1481 (2006); Patricia A. McCoy, *A Behavioral Analysis of Predatory Lending*, 38 AKRON L. REV. 725 (2005).

15. See *infra* Part II.B for a discussion of problems on the demand side of the home loan market.

16. See *infra* Part II.B.2 for a discussion of demand-side irrationality.

17. See *infra* Part III for a discussion of necessary consumer protections.

institutional impediments and conclude that none of the existing institutions are well equipped to debias consumers' decision-making processes.

Part IV concludes by emphasizing the need to explore the contours of institutional structure and regulatory options. While it suggests a framework for evaluating legislative reforms, we leave the development of this topic for future research.

II. FAILURES IN THE HOME LOAN MARKET

A. Imperfections on the Supply Side

In this section, we explain how the evolving dynamics of mortgage underwriting created incentives for mortgage originators to take advantage of biases in consumer decision making. The disaggregation of this market for home loans added agency costs: mortgage originators[18] and their gatekeepers did not have the same incentive as a conventional mortgage lender to guard against borrowers' default risk; investors in mortgage-backed securities bore the risk of borrowers' default, not mortgage originators. This shift created improper incentives for originators to approve loans and set mortgage terms.

Prior to roughly 1980, the structure of mortgage financing was fairly straightforward. Consumers borrowed money from banks (or other financial institutions) to finance the purchase of a primary residence, and banks in turn borrowed money from depositors and from the capital markets in order to finance these home loans. This traditional market had two attributes that matter. First, before securitization, banks held the mortgages for their own account; when a bank invested in a mortgage, it did so with the understanding that it was going to hold the credit in its portfolio of assets. This had certain effects on the cost and availability of home loans. When banks invested in residential mortgages, they borrowed from short-term capital markets to obtain the funds used to finance the loan. As a result, banks that engaged in mortgage lending faced risks that short-term interest fluctuations would not match long-term payment streams under the terms of the mortgage. Second, banks were highly regulated. The regulatory structure was one that was put in place initially in response to the bank runs of the Great Depression.[19] Regulators required banks to hold capital reserves in an

18. We use the term "mortgage originator" to refer to any entity that works with a borrower to complete a mortgage transaction. A "mortgage originator" can be a mortgage banker (such as a bank or credit union) or a mortgage broker; a mortgage originator is often, but not always, the original mortgage lender. Often, we do not distinguish between types of mortgage originators, as has been true of other commentators, because the market has tended to conflate the roles of various mortgage originators as well. "[T]he actual roles of brokers, loan officers, lenders, and others are not rigidly bounded and often blur." Morris M. Kleiner & Richard M. Todd, *Mortgage Broker Regulations that Matter: Analyzing Earnings, Employment, and Outcomes for Consumers*, *in* STUDIES OF LABOR MARKET INTERMEDIATION 183, 186 n.5 (David H. Autor ed., 2009).

19. *See generally* Banking Act of 1933, ch. 89, 48 Stat. 162 (codified in scattered sections of 12 U.S.C.), *repealed in part by* Gramm-Leach-Bliley Act, Pub. L. No. 106-102, 113 Stat. 1338 (1999) (codified as amended in scattered sections of 12 U.S.C. and 15 U.S.C.).

amount and of a type sufficient to match the liabilities on their balance sheets and satisfy liquidity requirements.

These interest rate risks and regulatory requirements created disincentives for financial institutions to extend mortgage credit to even the safest borrower, and as a result, credit constraints in the market for home loans were notoriously large, preventing many Americans from realizing the "American dream" of homeownership.[20] This, in turn, led to pressure to deregulate banks as manifested in the Garn–St. Germain[21] and Gramm-Leach-Bliley Acts.[22]

After 1980, a new method for raising capital for home mortgages evolved—mortgage-backed securitization.[23] Instead of holding mortgages for their own account, banks and mortgage brokers would "originate" a mortgage and then sell it to a trust, which would then bundle the mortgages into a "pool." The trust, or special purpose entity, would sell securities to the capital markets, backed by the payment streams from the mortgages it owned. The originator usually remained in the picture as a servicer for the purposes of collecting payments and enforcing the mortgage if necessary; it might also retain a residual interest in the very riskiest tranches of the mortgage pool. As such, the originator's economic interest, at least in the event of a real estate downturn, was largely limited to the fees it earned as an originator and servicer.

This shift to capital markets financing for home mortgages increased the availability of home loans for four related reasons, some of which were efficiency enhancing, and others of which were more ambiguous. First, because banks were no longer the only source of capital for home loans, competition increased. For example, under the bank-based model, the only way an investor with a few hundred thousand dollars to invest could purchase a portfolio of home mortgages was to buy bank stock or become a bank. This limited the extent to which markets disciplined the price of mortgages. Once mortgage-backed securities could be sold directly to the capital markets, mutual funds, small investors, and others could purchase mortgage-backed securities for their own portfolio without worrying about the health of the originating bank.[24] This increased competition for mortgage-backed assets was without a doubt market enhancing. Mortgages could be made available to a wider variety of borrowers.

Second, however, securitization operated as an end run around the bank regulation put in place to protect the safety, soundness, and security of the national banking structure at the end of the Great Depression. Traditional mortgage lenders faced underwriting restrictions on the kinds of loans they could make and hold for their own accounts, as well as capital restrictions that

20. U.S. Department of Housing and Urban Development, HUD Historical Background, http://www.hud.gov/ offices/adm/about/admguide/history.cfm (last visited Jan. 4, 2010).

21. The Garn–St. Germain Act deregulated the savings and loan industry. *See generally* Garn–St. Germain Depository Institutions Act of 1982, Pub. L. No. 97-320, 96 Stat. 1469 (codified at 12 U.S.C. § 226).

22. The Gramm-Leach-Bliley Act opened up the banking market. Phil Gramm, Op-Ed., *Deregulation and the Financial Panic*, WALL ST. J., Feb. 20, 2009, at A17.

23. *See* IMMERGLUCK, *supra* note 1, at 68–98 (discussing "high-risk revolution").

24. *See* Steven L. Schwarcz, *The Alchemy of Asset Securitization*, 1 STAN. J.L. BUS. & FIN. 133, 136–38 (1994) (discussing benefits of securitization, including less risk associated with originator).

constrained the amount of risk they could carry in their loan portfolio.[25] Securitized assets purchased for the bank's account were thought of as liquid, and thus, did not require offsetting reserves. Securitization thus evaded bank regulations that imposed underwriting restrictions and capital requirements.[26] While this move clearly reduced the cost of issuing home loans, the efficiency of this end run is open to question and depends on weighing the (in)efficiency of the underlying bank regulatory structure against the (in)efficiency of the capital markets approach to mortgage financing.

Third, the shift to capital markets financing allowed for a shift to risk-based pricing of mortgage-backed securities. This in turn led to a "democratization" of credit. Riskier consumers gained access to credit, regardless of whether they presented good or bad credit histories. Historically, financial institutions withheld mortgage credit from those deemed poor credit risks; a payment stream owed by individuals with poor credit histories was, reasonably, viewed by lending institutions as creating too much default risk.[27] Risk-based pricing (the ability to separate loans into distinct pools based on credit scores) enabled lenders to better match borrowers' cost of credit to their credit history, and permitted lenders to extend credit to a broader swath of the population. Without securitization, subprime mortgages would have remained a small segment of the market for home loans. With securitization, the number and proportion of subprime home loans grew at an incredible rate.[28]

Fourth, tranching, a technique used by securitizers to structure the securities backed by the pool, allowed the creation of mortgage-backed securities that had different risk attributes than the underlying mortgages contained in the pool. Tranching was important to the creation of a market for subprime loans, because many investors are limited in the type of investments that they can make. Many are limited to securities with an investment grade rating.[29] However, once a mortgage is in a pool, it does not have to be an investment grade mortgage for the pool to back an investment grade security. When a pool issued securities to the capital markets, it could issue the securities in tranches—or layers of debt protected by agreements regarding the priority in which payment would be made. The first tier of

25. *See* IMMERGLUCK, *supra* note 1, at 34–41 (discussing rise of securitization and new restrictions on mortgage-backed lenders).

26. *See* FRIEDRICH A. HAYEK, PRICES AND PRODUCTION 115–16 (2d ed. 1935) (describing credit system as pyramid consisting of four parts, one of which, "private credits," is subject to little regulatory authority); Bill Gross, *Beware Our Shadow Banking System*, CNNMONEY.COM, Nov. 28, 2007, http://money.cnn.com/2007/11/27/ news/newsmakers/gross_banking.fortune/ (discussing risks of unregulated shadow banking system); Paul McCulley, Pac. Inv. Mgmt. Co., *Global Central Bank Focus*, Aug. 2007, http://www.pimco.com/LeftNav/Featured+Market+ Commentary/FF/2007/GCBF+August-+September+2007.htm (discussing how "shadow banking system" is not subject to regulation).

27. Techniques for individualized risk assessment through risk-based pricing were first developed to price credit card debt.

28. *See* Press Release, Bd. of Governors of the Fed. Reserve Sys., Fed. Trade Comm'n, Agencies Issue Proposed Rules on Risk-Based Pricing Notices (May 8, 2008), http://www.federalreserve.gov/newsevents/press/bcreg/20080508a.htm (explaining risk-based lending).

29. *See* Ofdict.com, Investment Grade, http://www.ofdict.com/definition/investment-grade.php (last visited Jan. 5, 2010) (defining "investment grade").

this debt—the "A piece"—would be paid first, the "B piece" second, and the "C piece" third. The A piece could be configured with risk attributes that allowed for an investment grade and could be sold to mutual funds, government entities, and insurance companies. The B piece might be sold to hedge funds with a higher tolerance for risk; often, the C piece was retained by the servicer. Where a bank, investing for its own account, might not have been in a position to "invest in" subprime mortgages by extending credit to a consumer whose credit rating suggested a high risk of default, tranching made it possible for that same bank, or other investor, to invest in the A piece of a pool of subprime mortgages, while other investors with a greater tolerance for risk might invest in the B piece. Tranching thus allowed the creation of investment grade securities backed by pools of subprime (non–investment grade) mortgages.[30]

Supply-side gatekeepers are supposed to ensure that the value and risk attributes of the securities issued by a particular pool, or tranches within the pool, are accurately disclosed to the credit market. These supply-side gatekeepers come into play at two different points in the securitization process: at the loan initiation stage, when mortgages are supplied to the primary market for home loans, and at the securities underwriting stage, when mortgage-backed securities are supplied to the credit markets for purchase.[31] At the origination stage, the principal gatekeepers are appraisers and credit reporting agencies. The appraiser has the job of establishing the value of the collateral for the loan, and the credit reporting agency establishes the creditworthiness of the borrower. At the securities underwriting stage, the key gatekeepers are rating agencies, lawyers, and accountants, who establish that the pool contains mortgages with the advertised financial attributes, that the transfers to the pool have occurred through a "true sale" of the mortgages, and that the pool has been structured to withstand the bankruptcy of the originator.

The market for RMBS might not have collapsed had these gatekeepers done their jobs. Two problems undercut the integrity of this gatekeeping structure. First, originators' business model shifted from an investment model to a "sales" model. Second, rating agencies did not adjust to the fact that valuing mortgage pools was a fundamentally different exercise than valuing corporate debt.[32]

Originators made money by packaging loans for the secondary market, rather than by making wise investments. They devised mortgages designed to maximize the supply of home loans, without optimizing the risk of default associated with these mortgages. By the late 1990s, originators were "marketing" mortgage "products" that any rational lender, holding for its own account, clearly would

30. *See generally* Taylor D. Nadauld & Shane M. Sherlund, *The Role of the Securitization Process in the Expansion of Subprime Credit* (Dice Ctr., Working Paper No. 2009-9; Fisher Coll. of Bus., Working Paper No. 2009-03-009, 2009), *available at* http://ssrn.com/abstract=1410264 (providing detailed analysis of subprime mortgage-backed securitization).

31. One might posit a third tier of gatekeepers, such as Fannie Mae and Freddie Mac, who set standards for the RMBS that they will purchase on the capital markets.

32. *See* Joshua Coval et al., *The Economics of Structured Finance*, 23 J. ECON. PERSP. 3, 4 (2009) (describing how structured finance product issuers encouraged application of bond rating scale to structured finance products, which led investors to believe structured finance products were comparable to bonds and enabled "investors subject to ratings-based constraints" to purchase them).

have avoided. NINA (no income–no asset verification) and NINJA (no income–no job verification) mortgage loans seem in retrospect the height of sloppy underwriting, but originators believed that they held no concern for the risk of default in these loans, and underwriters believed that, if properly tranched and priced, the risk of default could be contained.[33]

In large part, this shift to a "sales" model of mortgage origination developed as mortgage brokers took greater responsibility for working with mortgage borrowers. Nonexistent in the 1970s, by 2006, mortgage brokers were responsible for originating between sixty-three and eighty-one percent of all subprime home loans, up from the forty-eight percent of all subprime loans they originated in 2003.[34] While mortgage brokers did not "sell" only subprime loans, they "sold" most of the subprime home loan products; in 2003, for example, mortgage brokers originated sixty-five percent of all home mortgages and forty-eight percent of the subprime home mortgages.[35] Indeed, one consumer advocacy group contends that

> [t]he rapid growth of subprime lending, which in the past decade grew from a small niche enterprise to a major driver of the U.S. housing market, was made possible by thousands of mortgage brokers across the country who delivered billions of dollars of subprime loans to mortgage lenders, who in turn packaged and sold them to Wall Street investors.[36]

Whether mortgage brokers' involvement in the origination of home loans has been market enhancing or problematic has been a topic of considerable debate. Several economists correlate mortgage brokers' origination of home loans to lower interest rates charged to consumer borrowers, thus concluding that mortgage brokers' involvement has led to increased competition in the market for home loans, particularly subprime loans.[37] Similarly, economists at the National Bureau of Economic Research conducted a study and concluded that states with higher net worth / bonding requirements for mortgage brokers were more likely to have higher priced mortgages and higher foreclosure rates than states with lower regulatory thresholds.[38] Commentators have questioned these results;[39] a consumer advocacy

33. *See* Steven Pearlstein, *"No Money Down" Falls Flat*, WASH. POST, Mar. 14, 2007, http://www.washington post.com/wp-dyn/content/article/2007/03/13/AR2007031301733_pf.html (discussing origin and effect of NINJA-type loans).

34. KEITH ERNST ET AL., CTR. FOR RESPONSIBLE LENDING, STEERED WRONG: BROKERS, BORROWERS, AND SUBPRIME LOANS 6 (2008).

35. AMANY EL ANSHASY ET AL., THE PRICING OF SUBPRIME MORTGAGES BY MORTGAGE BROKERS AND LENDERS 1 (2005), *available at* http://www.chicagofed.org/digital_assets/others/events/2005/promises_and_pitfalls/paper_ pricing.pdf; ERNST ET AL., *supra* note 34, at 6; *see also Licensing and Registration in the Mortgage Industry: Hearing Before the Subcomm. on Housing and Community Opportunity of the H. Comm. on Financial Servs.*, 109th Cong. app. at 70 (2005) (reporting that "mortgage broker operations across the nation . . . originate [sixty-five percent] of all residential loans in the U.S.").

36. ERNST ET AL., *supra* note 34, at 3.

37. EL ANSHASY ET AL., *supra* note 34, at 6.

38. Kleiner & Todd, *supra* note 18, at 34.

39. *E.g.*, PATRICIA A. MCCOY, BANKING ON BAD CREDIT: NEW RESEARCH ON THE SUBPRIME HOME MORTGAGE MARKET 8–13 (2005), *available at* http://www.chicagofed.org/digital_assets/others/events/2005/promises_and_pitfalls /remarks_mccoy.pdf.

group, conducting its own research, reached contrary results.[40] Because the data on which some of these economists relied involves proprietary information that is not publicly available, and because their report has not been published in a peer-reviewed journal, it seems unwise to conclude that mortgage brokers' involvement in the mortgage market caused lower prices until further research is conducted.

Regardless of one's opinion of the correlation between mortgage price and the involvement of a mortgage broker, there remains the issue of consumer borrowers' confusion as to mortgage brokers' relationship to them and to the compensation that mortgage brokers charge. Economic studies conducted by scholars at the Federal Trade Commission question the extent to which consumers are confused on this front,[41] but studies conducted by consumer advocacy groups, again, reach disparate results.[42] Whether or not consumers are confused about mortgage brokers' compensation, the structure of these fee arrangements clearly create incentives for mortgage brokers to "sell" the most loans at the highest price. If a mortgage broker can arrange a loan that pays an interest premium over the market rate for a particular borrower, the mortgage broker will be able to pocket this yield spread when it sells the loan to a pool.[43]

Other gatekeepers' compensation was also tied to the volume of deals done, each in their own way. Appraisers were often tightly tied to an originator, making it unlikely that an appraiser would issue an appraisal that questioned the wisdom of an originator's proposed loan amount. Indeed, Countrywide Home Loans actually owned its own appraisal subsidiary, LandSafe.[44] Similarly, rating agencies were only paid if the deals closed, creating strong disincentives for these agencies to question appraisers' and other professionals' opinions of the worth of the deal.[45]

40. ERNST ET AL., *supra* note 34, at 36–37 (stating that bonuses paid by lenders to mortgage brokers are "detrimental to competition").

41. *See* JAMES M. LACKO & JANIS K. PAPPALARDO, FED. TRADE COMM'N, THE EFFECT OF MORTGAGE BROKER COMPENSATION DISCLOSURES ON CONSUMERS AND COMPETITION: A CONTROLLED EXPERIMENT, at ES-1 (2004), *available at* http://www.iamp.biz/downloads/FTCSummary2004-02-27.pdf (noting proposed broker compensation disclosures confused consumers, and created a substantial consumer bias against broker loans, even when the broker loans cost the same or less than direct lender loans, because the disclosures would have been required of brokers but not direct lenders); *see also* JAMES M. LACKO & JANIS K. PAPPALARDO, FED. TRADE COMM'N, IMPROVING CONSUMER MORTGAGE DISCLOSURES: AN EMPIRICAL ASSESSMENT OF CURRENT AND PROTOTYPE DISCLOSURE FORMS 31 (2007) [hereinafter LACKO & PAPPALARDO, IMPROVING CONSUMER MORTGAGE DISCLOSURES], *available at* http://www.ftc .gov/os/2007 /06/P025505MortgageDisclosureReport.pdf (noting disclosures on other loan terms would improve consumer decision making).

42. *See* ERNST ET AL., *supra* note 34, at 5 (finding "common misperception by consumers").

43. *See, e.g.*, Peter J. Hong & Marcos Reza, *Hidden Costs to Homeowners: The Prevalent Non-disclosure of Yield Spread Premiums in Mortgage Loan Transactions*, 18 LOY. CONSUMER L. REV. 131, 132–34 (2005) (discussing "yield spread premiums" paid by lenders to brokers and their assessment according to interest rates on loans).

44. Mark H. Adelson, *Trends in Securitization: Commentary from a Rating Agency Perspective*, *in* NEW DEVELOPMENTS IN SECURITIZATION 1998, at 203, 246 (PLI Com. L. & Prac., Course Handbook Series No. 781, 1998).

45. *See* Claire A. Hill, *Regulating the Rating Agencies*, 82 WASH. U. L.Q. 43, 47 (2004) (discussing credit raters' control); Kenneth C. Kettering, *Securitization and Its Discontents: The Dynamics of Financial Product Development*, 29 CARDOZO L. REV. 1553, 1671–1702 (2008) (calling rating agencies de facto

Thus, the gatekeeping structures adopted by the RMBS market simply adapted preexisting underwriting institutions to the new market. The appraisal and credit evaluation architecture of traditional mortgage lending was married to the underwriting and rating architecture used for issuing capital markets securities. However, recent events have shown that this mixed marriage of mortgage lenders to securities issuers may have soured because it permitted the disaggregation of mortgage lending from mortgage holding. Separating these two functions removed incentives for originators to internalize borrowers' risk of default, but this separation alone would not have created conflicts between originators' interests and the interests of investors in mortgage-backed securities. It was the securitization of mortgage-backed securities in tranches of debt with distinct prices and distinct investment grades that confirmed this mismatch. And it was the lure of an ever-expanding market in easy subprime mortgage-based credit that fueled these conflicting interests. These attributes of the mortgage-backed securities market appear to be at the root of the subprime crisis.

B. Problems on the Demand Side

The story of supply-side gatekeepers has been told by others.[46] It is an unremarked side effect of this story, however, that is the focus of our concern—market failures on the supply side place the institutions that protect consumers on the demand side in high relief.

An element of unintentional consumer protection was eliminated from the market for home loans when it became possible for lenders to underwrite subprime mortgages. Bankers, as mortgage originators, no longer held incentives to impose strict underwriting standards in determining whether to originate a mortgage loan. Previously, underwriting standards had limited consumers' access to home loans by strictly scrutinizing borrowers' income and the value of the residential collateral. This constrained the supply of mortgage credit, but it also worked to minimize defaults in the market for home loans. While a persistent concern in policy-oriented literature on consumer credit has centered on the fact that many poorer communities had limited, if any, access to credit,[47] there existed little

lawmakers in absence of legal regulation); Timothy E. Lynch, *Deeply and Persistently Conflicted: Credit Rating Agencies in the Current Regulatory Environment*, 59 CASE W. RES. L. REV. 227, 261–65 (2009) (discussing lack of due diligence by credit rating agencies, using Enron as example); Frank Partnoy, *How and Why Credit Rating Agencies Are Not Like Other Gatekeepers*, *in* FINANCIAL GATEKEEPERS: CAN THEY PROTECT INVESTORS? 59, 81–89 (Yasuyuki Fuchita & Robert E. Litan eds., 2006) (discussing differences between credit agencies and other gatekeepers); Frank Partnoy, *The Siskel and Ebert of Financial Markets?: Two Thumbs Down for the Credit Rating Agencies*, 77 WASH. U. L.Q. 619, 622 (1999) (discussing importance of credit raters).

46. *See, e.g.*, Jonathan Macey et al., *Helping Law Catch Up to Markets: Applying Broker-Dealer Law to Subprime Mortgages*, 34 J. CORP. L. 789, 842 (2009) (stating that mortgages were offered to people who did not have sufficient income to repay loans, but brokers were not concerned because mortgages would be securitized); Kiff & Mills, *supra* note 4, at 7 (stating that "fee-driven remuneration" and "dispersion of credit risk" weakened existing protections that were designed to ensure careful lending practices).

47. *Compare, e.g.*, DEAN M. MAKI, *The Growth of Consumer Credit and the Household Debt Service Burden*, *in* THE IMPACT OF PUBLIC POLICY ON CONSUMER CREDIT 43 (Thomas A. Durkin & Michael E. Staten eds., 2002) ("Little evidence has been found that household debt service burdens are negatively related to future consumption . . . ."), *with* Philippe Bacchetta & Stefan Gerlach, *Consumption and Credit Constraints:*

concern about the need to protect consumers from overwilling lenders' overextensions of credit—until securitized subprime home loans entered the marketplace.[48]

1. Democratization of Credit and the Risks of Overleverage

Unquestionably, securitization led to some (if not overwhelming) democratization of consumer credit.[49] And some of this relaxed credit availability may have enabled more consumers to own their own homes. Home ownership rates increased in the United States between 1983 and 2007 from 64.9% to 68.1%.[50] Within this average, home ownership among African Americans rose from 45.6% to 47.8%, and, more impressively, home ownership among Hispanics rose from 41.2% to 49.7%.[51] Whether increased access to subprime home loans caused increases in home ownership rates is questionable, however. Data on home ownership show fairly steady increases from 1983 to 2004, but these increases level off and decrease slightly between 2004 and 2007.[52] When home ownership among African Americans is examined, the figures also peak in 2004 and decline thereafter; only Hispanics' home ownership increased steadily over the entire period, even between 2004 and 2007.[53]

The year 2004 is significant in these contexts, because it marks the point in time when subprime home loans substantially increased. Between 2001 and 2003, subprime home loans increased slowly but steadily.[54] By 2004, the number of nonprime mortgage originations increased to roughly $30 billion; within the next year, 2005, they more than doubled to $65 billion, thereafter declining slightly to roughly $50 billion by early 2006. Subprime home loans have been an important source of mortgages over this period. "Industry sources suggest that aggressive

International Evidence, 40 J. MONETARY ECON. 207, 234 (1997) (stating that individual's ability to consume can be predicted from that individual's credit), *and* Sydney Ludvigson, *Consumption and Credit: A Model of Time-Varying Liquidity Constraints*, 81 REV. ECON. & STAT. 434, 445 (1999) (concluding that growth of consumption in United States correlates with predictable growth of consumer credit). *See generally* Michael S. Barr, *An Inclusive, Progressive National Savings and Financial Services Policy*, 1 HARV. L. & POL'Y REV. 161 (2007) (arguing that lack of access to credit contributes to poverty and other problems).

48. *See, e.g.*, Kurt Eggert, *Limiting Abuse and Opportunism by Mortgage Servicers,* 15 HOUSING POL'Y DEBATE 753, 753 (2004) ("As securitization increases, so too does the need to protect borrowers whose loans are securitized from opportunism by the commercial participants in the securitization process."); Kathleen C. Engel & Patricia A. McCoy, *A Tale of Three Markets: The Law and Economics of Predatory Lending*, 80 TEX. L. REV. 1255, 1261 (2002) (discussing predatory loans as subset of subprime loans).

49. *See* Kiff & Mills, *supra* note 4, at 4 n.4 (noting that subprime lending allowed borrowers who would previously have been considered too risky to be approved for mortgages to borrow, which is demonstrated by six percent rise in homeownership in lower-income areas between 1995 and 2004 and four percent jump in higher-income areas).

50. *See* Jesse M. Abraham et al., *Explaining the United States' Uniquely Bad Housing Market*, 12 WHARTON REAL EST. REV. 24 (2008) (relying on data from U.S. DEP'T OF HOUSING & URBAN DEV., U.S. HOUSING MARKET CONDITIONS (2008)).

51. *Id.*

52. *Id.*

53. *Id.*

54. FED. DEPOSIT INS. CORP., FDIC OUTLOOK: BREAKING NEW GROUND IN U.S. MORTGAGE LENDING (2006), http://www.fdic.gov/bank/analytical/regional/ro20062q/na/2006_summer04.html.

lending instruments, such as interest only loans, negative amortization loans, low or zero equity loans, and teaser-rate [adjustable rate mortgages], accounted for nearly two-thirds of all U.S. loan originations since 2003."[55] Many of these subprime home loans merely involved refinancing of earlier mortgage transactions and so had no effect on the overall homeownership rate. Thus the effect of subprime lending on homeownership rates is ambiguous.

Even if the democratization of credit facilitated home ownership, subprime lending also increases the risk that small financial reversals will have substantial financial effects both for the lender and for the borrower. Elizabeth Warren, alone and with coauthors, has written extensively about borrowers' recent use of consumer credit to smooth short-term income shocks such as job loss or transition, or transitory costs such as an illness in the family.[56] Once the shock has passed, the family may not be in a position to retire the debt they have incurred and, as a result, are more exposed to a second shock than if they had adjusted their lifestyle rather than borrowing.[57] Similarly, Warren and her coauthors argue that over the last thirty years, families have increasingly become dependent on two incomes to cover household expenses, especially home mortgages.[58] A family that is dependent on two incomes is diversified, in the sense that the loss of one earner will not leave the family without resources, but the family is also subject to the risk of job loss faced by each wage earner.[59] If the loss of one income will cause a mortgage default, the riskiness of the system is again increased.[60]

2. Cognitive Limitations and Heuristic Biases

More problematically, a significant subset of consumers may be less than perfectly rational about borrowing decisions. Various cognitive biases make it difficult for many individual borrowers to weigh the costs and benefits of financing current consumption. For example, time inconsistent preferences (often caused by

55. Andrey D. Pavlov & Susan M. Wachter, *Subprime Lending and House Price Volatility*, 38 REAL EST. ECON. (forthcoming 2010) (manuscript at 3, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1489435) (citing FED. DEPOSIT INS. CORP., *supra* note 54).

56. *See, e.g.*, TERESA A. SULLIVAN ET AL., AS WE FORGIVE OUR DEBTORS: BANKRUPTCY AND CONSUMER CREDIT IN AMERICA 166–75 (1989) (discussing medical debt and its impact on families going bankrupt); TERESA A. SULLIVAN ET AL., THE FRAGILE MIDDLE CLASS: AMERICANS IN DEBT 2 (2000) [hereinafter SULLIVAN ET AL., THE FRAGILE MIDDLE CLASS] (classifying stresses on middle class families into five different categories); Robert M. Lawless et al., *Did Bankruptcy Reform Fail? An Empirical Study of Consumer Debtors*, 82 AM. BANKR. L.J. 349, 367–69 (2008) (stating that nonmortgage debt for homeowners rose greatly between 2001 and 2007); Teresa A. Sullivan et al., *Less Stigma or More Financial Distress: An Empirical Analysis of the Extraordinary Increase in Bankruptcy Filings*, 59 STAN. L. REV. 213, 232–33 (2006) (discussing jump in credit card debt among middle class families).

57. *See* SULLIVAN ET AL., THE FRAGILE MIDDLE CLASS, *supra* note 56, at 21 (discussing how increasing consumer debt lowers threshold for financial collapse).

58. *See generally* ELIZABETH WARREN & AMELIA WARREN TYAGI, THE TWO-INCOME TRAP: WHY MIDDLE-CLASS MOTHERS & FATHERS ARE GOING BROKE 28–32 (2003) (discussing "bidding war for suburban homes in good school districts" that forced women into job market to support increasing mortgages).

59. *Id.* at 81–82.

60. *See id.* (finding that two-income families faced increased risk of losing income, which could cause financial catastrophe).

hyperbolic discounting) result in consumers preferring present consumption over savings, although more conventional assumptions about the time value of money and preferences for risk would have led perfectly rational consumers to delay consumption to permit saving for the future.[61] Finally, there are a variety of heuristic biases, such as optimism bias and self-serving bias, which may cause consumers to underestimate the risk of their own default.[62] We have explored these heuristics in depth elsewhere,[63] but certain biases have particular applicability to the market for home loans. They include: (i) cognitive limitations; (ii) hyperbolic discounting; (iii) optimism bias; and (iv) endowment effects.

(i) Cognitive Limitations

To give a very crude example of how these biases manifest themselves in the market for subprime loans, recognize that first-time home buyers will always need to decide how much house they can afford. They may need 1,500 square feet and two bedrooms, but they might want 3,000 square feet with a swimming pool and three bedrooms. The first impediment to rational consumer decision making is the borrower's cognitive ability to understand the terms of the loan. House purchases are not simple transactions, even when they are routine.[64] Appraisals, surveys, and insurance—let alone compound interest, prepayment penalties, teaser rates, and negative amortization—may go well beyond the ability of the typical home buyer to understand the financial risks he or she is taking. Fannie Mae and Freddie Mac were very successful in solving many of these problems in the conforming loan

61. *E.g.*, Bar-Gill, *Seduction by Plastic*, *supra* note 14, at 1395–1408; Block-Lieb & Janger, *supra* note 14, at 544–45; Angela Littwin, *Testing the Substitution Hypothesis: Would Credit Card Regulations Force Low-Income Borrowers into Less Desirable Lending Alternatives?*, 2009 U. ILL. L. REV. 403, 431.

62. *See* Bar-Gill, *Subprime Mortgage Contracts*, *supra* note 14, at 1375–76 (discussing overconfidence bias in context of subprime mortgage lending); Block-Lieb & Janger, *supra* note 14, at 1542 (summarizing research on overconfidence bias and positing its likely effect on consumer borrowers); Jason J. Kilborn, *Behavioral Economics, Overindebtedness & Comparative Consumer Bankruptcy: Searching for Causes and Evaluating Solutions*, 22 EMORY BANKR. DEV. J. 13, 18–19 (2005) (suggesting that overconfidence causes consumers to underestimate potential events that could harm future income).

63. *See generally* Block-Lieb & Janger, *supra* note 14.

64. *See, e.g.*, Lise Héroux et al., *Consumer Product Label Information Processing: An Experiment Involving Time Pressure and Distraction*, 9 J. ECON. PSYCH. 195, 211 (1988) (finding that too much information on labels can be as unwanted as too little information); Jacob Jacoby et al., *Brand Choice Behavior as a Function of Information Load: Replication and Extension*, 1 J. CONSUMER RES. 33, 41 (1974) (finding "finite limits" to consumers' ability to internalize product information during limited time); Jacob Jacoby et al., *Brand Choice Behavior as a Function of Information Load*, 11 J. MARKET. RES. 63, 67 (1974) (noting that increasing product label information tends to create more customer satisfaction but poorer product selection); Naresh K. Malhotra, *Information Load and Consumer Decision Making*, 8 J. CONSUMER RES. 419, 422–23 (1982) (conducting cognitive experiment of human capacity to process complex information and concluding that respondents experienced information overload when provided with ten, fifteen, twenty, or twenty-five choice alternatives); Debra L. Scammon, *"Information Load" and Consumers*, 4 J. CONSUMER RES. 148, 154–55 (1977) (analyzing empirical finding and concluding that idea of "information overload" is not helpful in determining how consumers respond to information); Herbert A. Simon, *Theories of Decision-Making in Economics and Behavioral Science*, 49 AM. ECON. REV. 253, 269 (1959) (stating that formulation of expectations injects instability into otherwise stable market).

market.[65] They established standard form transactions and simplified the mortgage products that were available to midsized prime borrowers.

At least at the outset, securitization, standardization, and transparency worked hand-in-hand to make consumer mortgages simpler and easier to understand. That all changed when a market for securitized, nonstandard subprime mortgages emerged.[66] Subprime mortgages, by definition, deviate from the standard terms that govern conforming loans. These nonstandard products may involve teaser rates, balloons, negative amortization, prepayment penalties, and other terms that may mask the true cost of the loan.[67] More importantly, they make it very difficult for subprime borrowers to compare loan products. So, the first difficulty faced by subprime borrowers is their own ability to understand the terms of their mortgage. When a mortgage broker is in marketing rather than investing mode, there are tremendous incentives to encourage the borrower to take out as large a loan as possible. To do so, the broker may capitalize on the borrower's cognitive limitations to mask the loan's true cost. The borrower may therefore believe that the payment for the larger house is more manageable at closing, but he or she may not have anticipated resets, balloons, or other events that might belie this assumption.

(ii) Time Inconsistent Preferences

Somewhat more difficult to understand is the problem of hyperbolic discounting or time inconsistent preferences. Consumers tend to value present consumption much more highly than future consumption and also tend to devalue future risks.[68] In some instances, this lack of foresight occurs because consumers'

65. *See* Ronald J. Mann, *Searching for Negotiability in Payment and Credit Systems*, 44 UCLA L. REV. 951, 971 (1997) (noting that Fannie Mae and Freddie Mac have promulgated standard forms in home mortgage market).

66. *See generally* Julia Patterson Forrester, *Fannie Mae/Freddie Mac Uniform Mortgage Instruments: The Forgotten Benefit to Homeowners*, 72 MO. L. REV. 1077 (2007).

67. *See, e.g.*, Gregory D. Squires, *Urban Development and Unequal Access to Housing Finance Services*, 53 N.Y.L. SCH. L. REV. 255, 261 (2008) (discussing characteristics of subprime loans that may be problematic).

68. *See* Uri Benzion et al., *Discount Rates Inferred from Decisions: An Experimental Study*, 35 MGMT. SCI. 270, 271 (1989) (discussing experiment where discount rates are inferred from intertemporal choices of financially sophisticated students); Gretchen B. Chapman, *Temporal Discounting and Utility for Health and Money*, 22 J. EXPER. PSYCHOL.: LEARNING, MEMORY, & COGNITION 771, 771 (1996) (applying discounted utility theory to decisions regarding health and money); Gretchen B. Chapman & Arthur S. Elstein, *Valuing the Future: Temporal Discounting of Health and Money*, 15 MED. DECISION MAKING 373, 373 (1995) (demonstrating temporal discounting in health and money decisions); Stefano DellaVigna & Ulrike Malmendier, *Paying Not to Go to the Gym*, 96 AM. ECON. REV. 694, 694-96 (2006) (reporting choices regarding health club contract selection and usage that are contrary to time-consistent preferences and reasonable consumer expectations); George Loewenstein & Richard H. Thaler, *Anomalies: Intertemporal Choice*, 3 J. ECON. PERSP. 181, 191–92 (1989) (discussing research on intertemporal choices); John L. Pender, *Discount Rates and Credit Markets: Theory and Evidence from Rural India*, 50 J. DEV. ECON. 257, 257–60 (1996) (discussing idea that consumers discount the future); Donald A. Redelmeier & Daniel N. Heller, *Time Preference in Medical Decision Making and Cost-Effectiveness Analysis*, 13 MED. DECISION MAKING. 212, 212 (1993) (discussing time preferences toward health situations). *See generally* Richard Thaler, *Some Empirical Evidence on Dynamic Inconsistency*, 8 ECON. LETTERS 201 (1981) (discussing intertemporal choice in terms of discount rate evidence).

preferences for debt change over time, although contract terms may not match these changing preferences. In others, regret is caused by an individual's difficulties in assessing the risk of uncertain future events—difficulties made worse by consumers' too-frequent conclusions that bad events are more likely to happen to others than to themselves.

(iii) Heuristic Biases—Optimism

In addition to cognitive limitations and time inconsistent preferences, behavioral research suggests that consumers are subject to optimism bias. They tend to overestimate the stability and upward trajectory of their own income. They also tend to underestimate their own future borrowing and consumption needs.[69] This optimism bias may cause consumer borrowers to discount the risk associated with floating interest rates, increased payments due at the end of a teaser period, or the need to refinance due to a balloon in the mortgage. Moreover, they may not have anticipated the costs associated with homeownership, the birth of a first or a second child, the aging of a parent, or an unforeseen health crisis. Again, a mortgage broker principally interested in initiating the largest possible loan may seek to capitalize on this bias to convince consumers to take on more than they might ultimately be able to handle.

(iv) Heuristic Biases—Reliance on Experts

Moreover, this propensity for overborrowing may worsen when a mortgage broker or other perceived expert is involved in the transaction. Behavioral decision research also suggests that individuals rely excessively on "experts." In the market for home loans, borrowers may be expected to defer to those who identify themselves as experts, whether or not the experts' status is clearly established and whether or not the experts' advice makes sense. Behavioral research suggests that consumers are more likely to rely on advice where advice givers are perceived as more experienced than they are,[70] where the task is perceived as complex,[71] and

Experimenters also observe preference reversals—situations in which respondents prefer, for example, $110 in thirty-one days over $100 in thirty days, but also prefer $100 now over $110 tomorrow. *See generally* Leonard Green et al., *Temporal Discounting and Preference Reversals in Choice Between Delayed Outcomes*, 1 PSYCHONOMIC BULL. & REV. 383 (1994); Kris N. Kirby & R.J. Herrnstein, *Preference Reversals Due to Myopic Discounting of Delayed Reward*, 6 PSYCHOL. SCI. 83 (1995); Andrew Millar & Douglas J. Navarick, *Self-Control and Choice in Humans: Effects of Video Game Playing as a Positive Reinforcer*, 15 LEARNING & MOTIVATION 203 (1984); Jay V. Solnick et al., *An Experimental Analysis of Impulsivity and Impulse Control in Humans*, 11 LEARNING & MOTIVATION 61 (1980).

69. *See* Stefano DellaVigna & Ulrike Malmendier, *Contract Design and Self-Control: Theory and Evidence*, 119 Q.J. ECON. 353, 393–94 (2004) (using economic model to show that overconfidence hurts future self-control); DellaVigna & Malmendier, *supra* note 68, at 694-96 (reporting comparable findings for first year of annual contract holders).

70. *See, e.g.*, Nigel Harvey & Ilan Fischer, *Taking Advice: Accepting Help, Improving Judgment, and Sharing Responsibility*, 70 ORGANIZATIONAL BEHAV. & HUM. DECISION PROCESSES 117, 129 (1997) (finding that novice decision makers are more inclined to take advice from those whom they regard as more highly trained); Janet A. Sniezek & Lyn M. Van Swol, *Trust, Confidence, and Expertise in a Judge-Advisor System*, 84 ORGANIZATIONAL BEHAV. & HUM. DECISION PROCESSES 288, 298 (2001) (reporting study that decision makers with less expertise tend to trust their advisors more). *See generally* Janet A. Sniezek & Timothy Buckley, *Cueing*

where advisers are paid (or prepaid) for their advice.[72] Relying on expert advice may be good or bad, depending on the accuracy and bias of the advice received. Economic research questions the welfare-enhancing effects of a decision maker's reliance on expert advice,[73] concluding, for example, that it is always more desirable for decision makers to seek the advice of multiple experts biased in opposite directions than either a single biased expert or multiple experts biased in the same direction.[74]

While disclosure is often viewed as resolving the potentially harmful effects of biased expert advice in the market, important research questions this common-sense conclusion. George Loewenstein and his coauthors instead found that "disclosure may fail to solve the problems created by conflicts of interest" and, more problematically, "may sometimes even make matters worse."[75] This research found that participants did not sufficiently discount advice from biased advisors, even when the advisors' conflicted interests were disclosed to them, which they attribute, in part, to the fact that "people have trouble unlearning, ignoring, or suppressing the use of knowledge (such as biased advice) even if they are aware that it is inaccurate."[76] Lowenstein and his coauthors posited that disclosure elicited affirmatively harmful effects on the grounds that biased advisors who were required to disclose their conflicts of interest consequently felt a "moral license"[77] and strategic encouragement[78] to exaggerate their advice even further.

3. Implications?

Systematic cognitive limitations and heuristic biases may have introduced costs and risks into the financial system in a number of ways:

- *Personal cost.* The personal costs associated with the simple fact that a consumer makes an erroneous decision about his or her own preferences for present or future consumption are obvious. If consumer borrowers cannot be relied upon to accurately assess the risk of their own default, and supply-side gatekeepers' conflicts of interest also raise questions as to their incentives to

and Cognitive Conflict in Judge-Advisor Decision Making, 62 ORGANIZATIONAL BEHAV. & HUM. DECISION PROCESSES 159 (1995).

71. *E.g.*, Francesca Gino & Don A. Moore, *Effects of Task Difficulty on Use of Advice*, 20 J. BEHAV. DECISION MAKING 21, 27 (2007) (concluding that people tend to weigh advice more significantly when facing more difficult tasks than when facing easier tasks).

72. *E.g.*, Francesca Gino, *Do We Listen to Advice Just Because We Paid for It? The Impact of Advice Cost on Its Use*, 107 ORGANIZATIONAL BEHAV. & HUMAN DECISION PROCESSES 234, 243 (2008) (arguing that people weigh advice more heavily when it costs money than when it is gratuitously given); Janet A. Sniezek et al., *Improving Judgement with Prepaid Expert Advice*, 17 J. BEHAV. DECISION MAKING 173, 174 (2004) (stating that judge is more likely to expect highly accurate advice from paid expert witness).

73. *See generally* Vincent P. Crawford & Joel Sobel, *Strategic Information Transmission*, 50 ECONOMETRICA 1431 (1982).

74. Vijay Krishna & John Morgan, *A Model of Expertise*, 116 Q.J. ECON. 747, 762 (2001).

75. Daylian M. Cain et al., *The Dirt on Coming Clean: Perverse Effects of Disclosing Conflicts of Interest*, 34 J. LEGAL STUD. 1, 1 (2005).

76. *Id.* at 6 (citation omitted).

77. *Id.* at 7.

78. *Id.* at 1.

optimize borrowers' risk of default, then mortgages may be both larger and riskier than they would have been if either perfectly rational borrowers had entered into the mortgages or if supply-side gatekeepers' incentives had been better aligned.

- *Externalities*. There are also social welfare costs that derive from the fact that, system-wide, borrowers are more leveraged than rational borrowers would have been: social costs to overleveraged borrowers' family members, who suffer the economic and psychic costs of default and foreclosure, as well as social costs to communities, who bear the brunt of neighborhoods blighted by the empty houses and decreased real estate values that foreclosures cause. But these are only the most obvious costs.
- *Inefficient resource allocation*. Housing, and therefore mortgage payments, competes with other forms of consumption. To the extent that consumers make erroneous decisions about how much to borrow to pay for their houses, they live with the cost of that decision in later periods. Therefore, even a family that never defaults may be forced to make other choices that are not welfare maximizing, such as foregoing schooling, piano lessons, or orthodontia.
- *Inefficient asset pricing*. These social welfare costs are compounded when one considers the risk to investors. There is a tendency to think about this risk only in terms of the rational investors who purchase the asset-backed securities.[79] They understand their own risk and yield preferences and can choose their investments accordingly. But a housing market that is fueled by the existence of a new form of financing will become riskier across lending portfolios. To the extent that real estate prices, and hence collateral values, increased due to an increased demand for houses brought about by the newer, riskier hybrid mortgages,[80] the mortgages that fueled the increase will be riskier, because they are subject to an increased risk of diminution in housing values.[81]

In short, even in a world with rational lenders who engage in accurate risk-based pricing, behavioral decision research suggests that consumers have a systematic tendency to overborrow. This overborrowing has social welfare costs, which are compounded in a world where agency costs in the financial services market create incentives to overlend. The move from traditional mortgage lending to mortgage-backed securities increased the riskiness of mortgage lending, both to individual borrowers and to the financial system as a whole. The architecture for controlling this risk focused on lenders' incentives to minimize (or at least optimize) borrowers' risk of default. When the market shifted from a face-to-face to a

79. Investors face informational and cognitive limitations and are sometimes subject to irrational exuberance. Schwarcz, *supra* note 8, at 382–83.

80. *See, e.g.*, Abraham et al., *supra* note 50 (constructing theoretical model to demonstrate that supply of aggressive lending instruments temporarily increases asset prices in underlying market, and using local and national price index data to confirm model's predictions).

81. *See, e.g.*, John Patrick Hunt, *Credit Rating Agencies and the "Worldwide Credit Crisis": The Limits of Reputation, the Insufficiency of Reform, and a Proposal for Improvement*, 2009 COLUM. BUS. L. REV. 109, 121–23 (discussing how low quality credit agency ratings of subprime mortgages led to lack of confidence in securitized products in general).

capital markets model of mortgage financing, the task of optimizing default risk fell on supply-side gatekeepers: the appraisers, credit reporting agencies, and rating agencies that participate in the packaging of mortgages into mortgage-backed securities. But, for the reasons discussed above, these gatekeepers have proven to be imperfect.

While the current financial crisis may yet create a political will for regulation or reregulation of financial actors, especially those whose actions hold the potential for systemic failure, questions remain as to the contours of this regulation.[82] This may increase the effectiveness of supply-side gatekeepers, though questions will no doubt remain as to whether enhanced regulation of gatekeepers can fully erase the conflicting interests they face. More importantly, however, questions remain as to whether supply-side regulation alone is sufficient. There has been almost no attention paid to institutions on the demand side that might also help to alleviate the various risks created by the modern mortgage market. We turn to these gatekeepers in the next section.

III. CAN GATEKEEPERS RESOLVE DEMAND-SIDE FAILURES IN THE MARKET FOR HOME LOANS?

The failure of gatekeepers on the supply side of the home mortgage market is understood.[83] Efforts to remedy these problems have been proposed, although their legislative future remains uncertain years after the emergence of the subprime mortgage crisis.[84] Little thought has been given to institutions for limiting the

82. Some have criticized the use of behavioral decision research as a justification for regulating loan terms. *See, e.g.*, Richard A. Epstein, *The Neoclassical Economics of Consumer Contracts*, 92 MINN. L. REV. 803, 822–35 (2007) (claiming that other more conventional efficiency-based explanations, such as industry structure and security of information, are of greater import than behavioral economics). Some have criticized the reliance on experimental data, arguing that where real world decisions are being made with real money, consumers will not be subject to the same errors. Ronald Mann has also criticized this argument for regulating loan terms by contending that the principal problem with consumer borrowers is that they confuse borrowing decisions with consumption decisions. RONALD J. MANN, CHARGING AHEAD: THE GROWTH AND REGULATION OF PAYMENT CARD MARKETS 69 (2006) (stating that there is direct correlation between credit card spending and borrowing such that as consumption through credit card spending increases, borrowing also increases). He argues that when consumers use their credit cards, they simply do not focus on the fact that they are incurring (sometimes quite expensive) debt. Ronald J. Mann, *Unsafe at Any Price?*, 157 U. PA. L. REV. PENNUMBRA 167, 171 (2009), http://ww.pennumbra.com/responses/02-2009/Mann.pdf (finding that consumers find it difficult to assess risk inherent in credit card spending, as opposed to consumer products). Mann's observation may make sense when one is looking at credit cards. Where mortgages are involved, however, consumers are generally *not* confused about the *fact* that they are borrowing. They are, however, frequently confused about the *terms* of their loan and the real cost in terms of future consumption that attends their decision to borrow.

83. *See, e.g.*, Hunt, *supra* note 81, at 120–23 (discussing role of rating agencies in subprime mortgage crisis); Lois R. Lupica, *The Consumer Debt Crisis and the Reinforcement of Class Position*, 40 LOY. U. CHI. L.J. 557, 584 (2009) (stating that lax mortgage underwriting and predatory lending, among other things, led to present consumer debt crisis); David J. Matthews, Comment, *Ruined in a Conventional Way: Responses to Credit Ratings' Role in Credit Crises,* 29 NW. J. INT'L L. & BUS. 245, 246–47 (2009) (describing how irresponsible and predatory practices of mortgage lenders harmed numerous subprime loan borrowers).

84. *See, e.g.*, DEP'T OF THE TREASURY, FINANCIAL REGULATORY REFORM: A NEW FOUNDATION (2009), *available at* http://www.financialstability.gov/docs/regs/FinalReport_web.pdf (outlining proposed reforms that would give government more authority to regulate financial institutions).

costs of consumer decision-making errors on the demand side. In this section we explore the various possible demand-side gatekeeping institutions and assess whether they are up to the task.

A. Supply-Side Gatekeepers

On the supply side, capital markets need information, and supply-side gatekeepers are thought to have comparative advantages in gathering and disseminating information. As a theoretical matter, gatekeepers are essential because they solve a collective action problem. Where investors in a company or securitization pool are involved, no individual investor has the incentive or wherewithal to learn about the details of the investment. They care about its risk attributes, and no more. Gatekeepers provide that information. This information grants or denies a mortgage (or pool of mortgages) access to capital markets financing.[85]

B. Demand-Side Gatekeepers

On the demand (or consumer) side of the market for home loans, there is no similarly well-developed theory of gatekeepers. The reason inheres in the very nature of consumer transactions. Consumers act as individuals: they face no collective action problem, and, in theory at least, no information problem. An individual knows what resources he or she may have at his or her disposal, and an individual knows what he or she wants. This assumption about the rationality, or at least coherence, of individual preferences underlies a widespread belief in consumer autonomy. But, in a world where individuals are understood to be imperfectly rational (due to cognitive limitations, time inconsistent preferences, and heuristic biases), the presumption that markets can rely on rational actors to maximize social welfare is subject to question. In that world, borrowers are likely to make mistakes about the extent to which certain borrowing or consumption decisions may be affordable in current periods or consistent with their decisions about consumption in future periods. They may not fully understand certain credit terms, and they may underestimate the likelihood of future income shocks. Thus, while it may seem counterintuitive at first, the market for home loans may require a certain amount of "gatekeeping" on the demand as well as the supply side.

Demand-side gatekeeping might take a number of forms. It may be in the form of institutions to protect consumers from particularly deceptive or dangerous financial products. It might also be in the form of fiduciaries that help to counsel consumers about consumption and borrowing decisions. It could be in the form of communal norms about consumption or frugality, or it could even be in the form of paternalistic communities (such as co-op boards or homeowners associations) that deny access to people who they deem unable to afford a particular item of

85. *See, e.g.*, Hamdani, *supra* note 8, at 63 (defining function of gatekeepers); Kraakman, *supra* note 11, at 94 (claiming that investors rely upon established and reputable gatekeepers to monitor new issuers and verify issuer representations).

consumption. In this section we explore these various types of demand-side gatekeepers.

If borrowers are biased in favor of overborrowing, are there institutions on the demand side that might help debias consumer decision making? Are there gatekeepers on the demand side of mortgage transactions that can alleviate borrowers' cognitive biases and assist borrowers in avoiding improvident borrowing? In thinking about this question, we start by identifying the various institutions that intersect with a home buyer on the way to buying a house. A typical home buyer deals with the following people: (1) a seller; (2) the seller's broker; (3) possibly (but not usually) a broker who represents the buyer; (4) a mortgage lender; (5) a lawyer for the mortgage lender; (6) a title insurance company;[86] (7) sometimes (but not always) a lawyer for the buyer; (8) sometimes (but not always) a co-op board or condominium homeowners association. (9) Some borrowers, particularly low-income, first-home buyers, may have obtained housing counseling in preparation for homeownership. A few may have attended financial literacy classes in one place or another. In addition to these people, who intersect directly with a real estate transaction, there are also some more distant institutions that affect the transaction. In many states, (10) realtors' associations gather to draft standard form purchase and sale contracts to facilitate transactions.[87] Legislatures regulate lending transactions through statutes like the Truth in Lending Act,[88] the Home Ownership and Equity Protection Act,[89] the Real Estate Settlement Procedures Act,[90] or federal, state, or local legislation prohibiting deceptive trade practices; while we understand that legislatures are not gatekeepers per se, legislation can and often does regulate mortgage lending and indeed prohibit certain lending practices and transactions. [91]

Each of these participants in the market for home loans provides a possible point of access for debiasing consumer borrowing decisions. Broadly speaking, these actors can be cast in one of several possible roles: the traditional gatekeeper's role of information intermediary, the role of fiduciary, the role of

86. *See generally* JAMES L. GOSDIN, TITLE INSURANCE: A COMPREHENSIVE OVERVIEW (3d ed. 2008).

87. *See generally* Seth Weissman, Ga. Ass'n of Realtors, *Riding the Wave of Change: Reviewing the 2008–2013 GAR Purchase and Sale Agreement* (2007), http://www.garealtor.com/MemberCenter/ContractForms/PurchaseSale AgreementFAQs/tabid/94/Default.aspx.

88. Truth in Lending Act, Pub. L. No. 90-321, 82 Stat. 146 (1968) (codified at 15 U.S.C. § 1601 (2006)).

89. Home Ownership and Equity Protection Act of 1994, Pub. L. No. 103-225, 108 Stat. 2109 (codified at 15 U.S.C. § 1649).

90. Real Estate Settlement Procedures Act of 1974, Pub. L. No. 93-533, 88 Stat. 1724 (codified as amended at 12 U.S.C. §§ 2601–2617 (2006)).

91. Section 5 of the Federal Trade Commission Act prohibits "unfair or deceptive acts or practices." 15 U.S.C. § 45(a)(1). Many states have adopted "Little FTC Acts" and other consumer protection legislation to regulate deceptive practices. *See, e.g.*, FLA. STAT. ANN. § 501.204 (West 2009) (making unfair and deceptive trade practices unlawful); MICH. COMP. LAWS ANN. § 445.903 (West 2009) (making unconscionable trade practices unlawful); N.Y. GEN. BUS. LAW § 349 (McKinney 2009) (prohibiting deceptive acts and practices); Michael Isaac Miller, Comment, *The Class Action (Un)Fairness Act of 2005: Could It Spell the End of the Multi-state Consumer Class Action?*, 36 PEPP. L. REV. 879, 887–90 (2009) (describing four broad categories of Little FTC Acts that have been adopted by various states).

counselor/educator, the role of trading partner with disclosure obligations, the role of trading partner with limits on behavior, or the role of third-party regulator. To allocate the various participants to these categories, lenders and co-op boards can be considered traditional gatekeepers. Buyers' brokers and purchasers' attorneys fall into the category of fiduciaries for the purchaser. Under the current structure, no standard participant in the home purchase transaction is tasked with educating or counseling the borrower/purchaser. Lenders have certain disclosure obligations and certain limits on their behavior. And finally, the possible third-party regulators consist, in varying degrees, of realtor trade associations, zoning boards, and state and federal legislators.

1. True Gatekeepers

Historically, the principal gatekeepers on the demand side were the lenders and the various institutions that corroborated the lenders' underwriting decisions (such as credit reporting agencies and appraisers). However, for the reasons that we discussed above, these gatekeepers do not focus on the consumer's borrowing decisions, only on the prospects for repayment, and, in the capital markets model of home lending, they do this only imperfectly.

In some housing transactions, however, the borrower/buyer, the seller, and the mortgage lender are not the only entities that take an interest in the transaction. Co-op boards, condominium associations, and homeowners associations sometimes take an interest in the financial position (and sometimes even the identity) of the purchaser of a home. For example, cooperative associations often require significant down payments to purchase co-op shares, or require that the purchaser have liquid assets well in excess of the amount of the mortgage.[92] This interest in the buyer's financial situation is, at least in part, aimed at minimizing default risk. Cooperative associations and homeowners associations generally take a subordinate position to the mortgage lender with regard to common fees, so they may actually be more conservative than the lender. The greatest weakness of these institutions is that they are sometimes too selective, using various criteria to exclude qualified but less wealthy buyers.[93] More importantly, relatively few home purchase transactions are subjected to the scrutiny of these boards. Most home buyers look to purchase single residences; the only financial qualifications imposed in the bulk of home buying and home borrowing transactions, then, involves only the financial qualifications imposed by the mortgage originator.

Many consumer borrowers use a mortgage broker to find their mortgage.[94] Ideally, the mortgage broker should look to locate a mortgage at the lowest cost

92. For examples of sales contracts for co-op units, see docstoc.com, Contract of Sale—Cooperative Apartment, http://www.docstoc.com/docs/3006479/CONTRACT-OF-SALE--COOPERATIVE-APARTMENT (last visited Jan. 7, 2010); Sample Condominium Agreement, http://realestate.findlaw.com/condos-coops/le15_g.html (last visited Jan. 7, 2010).

93. These organizations may also impose other conditions on the buyers that are not related to financing, but they are not relevant for our purposes.

94. See *supra* notes 34–35 and accompanying text for statistics regarding percentage of instances in which mortgage brokers are involved in mortgage transactions.

available in the marketplace for a borrower with a similar credit history. Ideally, the mortgage would also be suitable for the borrower—in the sense that the borrower would have sufficient income to comfortably make the payments and attend to the other aspects of his or her life. While mortgage brokers may have competed for customers on the basis of price and product, they left the issue of the mortgage's sustainability to the borrower, the mortgage lender, and, ultimately, to investors in the market for RMBS. To make matters worse, mortgage brokers often were paid by the buyer for locating the mortgage at a rate equal to a percentage of the mortgage transaction; some were also paid a finder's fee and other fees, such as a yield spread premium, by the mortgage originator. As a result, mortgage brokers had every interest in maximizing the principal amount of the mortgage transaction and no interest in minimizing a borrower's risk of default.

2. Fiduciaries

A fiduciary is a person who owes a duty, usually of care and loyalty, to another because he or she is in a position of trust.[95] In a home purchase transaction, there are relatively few people who owe a fiduciary duty to the buyer. As a general rule, the real estate agent is an agent of the seller. This, in and of itself, is surprising to many home buyers, and most states require agents to disclose their relationship with the seller. There are real estate agents who function as buyers' brokers, representing the buyer, and in some jurisdictions, New York for example, it is customary for buyers to bring their own lawyers to the table.[96] In a small number of states, mortgage brokers are viewed as fiduciaries of the borrower.[97] It is therefore worth taking a moment to think about whether these "fiduciaries" serve, in those jurisdictions where they are common, as a protection against overborrowing by the buyer. The short answer, though, is likely no.

There are reasons that buyers' brokers have not become more commonplace. First, like sellers' brokers, buyers' brokers have an inherent tension in the interests they represent. They are compensated through a percentage of the sale price. In other words, they don't get more money if they get the buyer a better deal,

95. *See, e.g.*, Corbett v. Snyder, 6 Pa. D. & C.5th 49, 58 (Ct. Com. Pl. 2008) (noting that fiduciary duty requires acting candidly, honestly, and loyally in another's best interests).

96. Since legal representation is a matter of practice, not regulation, we offer our own multistate experiences as borrowers at real estate closings to support this claim.

97. Mortgage brokers are held to fiduciary standards in some states. *See, e.g.*, Rushing v. Stephanus, 393 P.2d 281, 283–84 (Wash. 1964) (finding mortgage broker liable for fraud, negligence, and breach of fiduciary duty); Wyatt v. Union Mortgage Co., 24 Cal. 3d 773, 784 (1979) ("[T]he broker's failure to disclose orally the true rate of interest, the penalty for late payments or the swollen size of the balloon payment clearly constituted breach of the broker's fiduciary obligations."); Myer v. Preferred Credit, Inc., 766 N.E. 2d 612, 631 (Ohio Ct. Com. Pl. 2001) (finding that mortgage broker breached fiduciary duties by failing to disclose dual representation of mortgagee and mortgagor and yield spread premium that it earned on closing of mortgage transaction); Haser v. Wright, No. CA003640A, 2002 WL 31379971, at *4 (Mass. Super. Ct. Sept. 4, 2002) (finding breach of fiduciary duty in mortgage broker's submission of false income information); LaSalle Bank Nat'l Ass'n v. Bardales, No. CV085007137, 2009 WL 1312509, at *9 (Conn. Super. Ct. Apr. 14, 2009) (finding mortgage brokers have fiduciary relationship with clients). *But see* Shovak v. Long Island Commercial Bank, 858 N.Y.S.2d 660, 663 (App. Div. 2008) (finding plaintiff failed to show fiduciary duty owed by defendant–mortgage broker).

they get less. In addition, they are only compensated if the sale closes, so, again, they do not do better if the buyer avoids an unsustainable mortgage, they do worse. As such, many buyers question whether a buyers' broker adds much to the transaction. Second, many buyers are concerned that having a buyers' broker may make it more difficult to negotiate with the two brokers over reducing the broker's commission. For both these reasons, buyers' brokers do not look like promising demand-side gatekeepers. Some of these problems might be ameliorated by altering the compensation structure, so that buyers' brokers are paid on an hourly basis, rather than a percentage basis, but the problem here arises when a buyer expects to look at many houses and invests lots of time in the search. Brokers are willing to do lots of work for free because of the anticipated percentage payoff on closing. Paying a buyers' broker on an hourly basis would increase the costs faced by buyers in gathering information.

Attorneys might seem more promising as demand-side gatekeepers. But they too are an imperfect institution. First, while practice varies, in many jurisdictions, the only lawyer involved in the transaction represents the bank extending the purchase money mortgage. The seller and buyer may be unrepresented. When this is the case, the responsibility of the lawyer is to attend to the mechanics of the conveyance, the perfection of the bank's mortgage, and the issuance of title insurance in favor of the lender. Moreover, many borrowers are told that lenders' counsel represent their interests relating to the mortgage, and this is true, up to a point. Borrowers and lenders hold identical interests in ensuring that the mortgage agreement complies with applicable law and that the property is transferred in fee simple with marketable title. But legal issues differ from economic considerations—lenders' counsel have no particular interest in assessing whether the mortgage terms—price or nonprice—are fair to the borrower or whether the mortgage amount is affordable for the borrower. And while historically, lenders had every interest in assessing their borrower's risk of default and extending mortgage credit that optimized the risk that the borrowers in their mortgage portfolio subsequently would default, as we learned in the last section, mortgage originators who look to transfer mortgages nearly immediately after the closing to a securitized pool have no such interest.

Buyers always have the option to bring their own lawyer, and in some jurisdictions, such as New York, it is customary for the buyer and seller to be separately represented. The buyer's attorney is a promising gatekeeper for a number of reasons. First, the attorney/client relationship imposes fiduciary obligations in favor of the buyer.[98] Second, attorneys are traditionally paid on an hourly basis, whether or not the transaction closes. Therefore they are not invested in the transaction itself.

However, there are a number of reasons why buyers' lawyers may not be well situated to debias a consumer's borrowing decision. First, lawyers generally only become involved in the transaction after a house has been identified and a price established by contract. Therefore buyers only spend money on a lawyer when the

98. *See, e.g.*, Int'l Strategies Group, Ltd. v. Greenberg Traurig, LLP, 482 F.3d 1, 6–7 (1st Cir. 2007) (stating that attorney-client relationship results in fiduciary duty to client).

transaction is relatively likely to close. As such, the consumer may already be very heavily invested in the transaction before the lawyer becomes involved. There is a bigger problem, though. Attorneys have the wrong expertise. Their expertise is in the legalities associated with the purchase and sale transaction, not with the economics of the mortgage. When representing consumers in real estate transactions, lawyers advise their clients on the legal issues surrounding the purchase and sale of a home, but generally do not advise their clients on the terms or sustainability of their mortgage. Indeed, many lawyers would feel uncomfortable being asked to serve as a "financial" rather than "legal" counselor and would not have the slightest idea how to fulfill a duty to "counsel" in that regard.

3. Housing Counseling and Financial Literacy Education

Another demand-side institution is one-on-one counseling or financial literacy training courses.[99] Some high-risk borrowers may have sought the advice of a housing counselor before deciding to purchase a home. The 1968 Housing and Urban Development Act established the Department of Housing and Urban Development ("HUD") as a cabinet-level agency and included a housing counseling program as a part of HUD's original mission.[100] Congress instructed HUD to "recruit, train, and certify non-profit organizations who would provide counseling services voluntarily to families seeking to purchase homes," and HUD began to certify housing counselors as early as 1971.[101] By 1994, 244,000 individuals received one-on-one counseling from HUD-certified counseling agencies; by 2007, roughly 1,800 HUD-approved housing counseling agencies provided 1.7 million individuals and families in communities across the country with housing counseling.[102]

Ideally, housing counselors would engage in a comprehensive assessment of the consumer's credit history, as well as the consumer's income and expenses. If the counselor deems the consumer's ratio of income to expenses too high, he or she might advise the consumer on which expenses were too high and how to spend less on targeted areas; if the consumer's credit history was poor, the counselor

99. We are not talking in this context about mandatory credit counseling, which since 2005 has been required of virtually all consumer debtors seeking access to bankruptcy, whether Chapter 7 liquidation, Chapter 13 debt-repayment cases, or otherwise. 11 U.S.C. § 109(h) (2006). This credit counseling mandate is not designed to assist individuals to make choices about home loans, but rather to assist them in making choices about whether a bankruptcy filing is the best mechanism for addressing their financial problems. Whether this mandate can achieve even this goal has been questioned. U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-07-203, BANKRUPTCY REFORM: VALUE OF CREDIT COUNSELING REQUIREMENT IS NOT CLEAR (2007), *available at* http://www.gao.gov/new.items/d07203.pdf. But this is a question outside the scope of this Paper.

100. Housing and Urban Development Act of 1968, Pub. L. No. 90-448, 82 Stat. 476 (codified as amended at 42 U.S.C. § 1441 (2006)); *see also* GEORGE W. MCCARTHY & ROBERTO G. QUERCIA, BRIDGING THE GAP BETWEEN SUPPLY AND DEMAND: THE EVOLUTION OF THE HOMEOWNERSHIP, EDUCATION, AND COUNSELING INDUSTRY, at 4 (Research Inst. for Housing Am., Institute Report No. 00-01, 2000) (discussing legislative history of homeownership education and counseling); U.S. DEP'T OF HOUS. & URBAN DEV., REPORT TO CONGRESS ON HOUSING COUNSELING 8 (1983) (discussing Housing Counseling Program).

101. CHRISTOPHER E. HERBERT ET AL., U.S. DEP'T OF HOUS. & URBAN DEV., THE STATE OF THE HOUSING COUNSELING INDUSTRY 9 (2008) (quoting U.S. DEP'T OF HOUS. & URBAN DEV., *supra* note 100).

102. *Id.* at 1.

might help the consumer to repair this by repaying past due bills. HUD helps ensure that housing counselors behave "ideally" by certifying some counselors as meeting its approved standards, but the agency does not have the staff or funding to audit or otherwise review HUD-approved housing counselors as regularly as might be desired. There exists some data to support the claim that housing counseling is effective, but this data is scant and not peer reviewed.[103] Moreover, access to housing counseling, while more accessible than in previous years, is not widespread and hardly ever free.[104]

In the absence of stronger data, we remain only cautiously optimistic about the prospects for housing counseling to debias consumer decision making. Our caution turns on the knowledge that their cousins, the more traditional "credit counseling" agencies, have in the past behaved less than ideally.[105] And often a single agency may perform both housing counseling and traditional credit counseling for its clients. At least in the past, some traditional credit counselors convinced consumers to enter into unaffordable debt management plans that benefited the counseling agency more than the consumer, especially those "nonprofit" credit counseling agencies that received tax deductible contributions from credit card companies and other financial institutions.[106] Some of these debt management plans directed funds to creditors that had provided funding to credit counseling agencies but not to other of the borrowers' lenders, with the result that some debtors found themselves with worse credit histories than they otherwise might have had.[107]

103. *See, e.g.*, Abdighani Hirad & Peter M. Zorn, *Pre-Purchase Homeownership Counseling: A Little Knowledge Is a Good Thing*, *in* LOW-INCOME HOMEOWNERSHIP: EXAMINING THE UNEXAMINED GOAL 146, 155-57 (Nicolas P. Retsinas & Eric S. Belsky eds., 2002) (discussing effectiveness of homeownership counseling); CHRISTI BAKER & J. MICHAEL COLLINS, NEIGHBORWORKS AM., MEASURING THE DELIVERY COSTS OF PREPURCHASE HOMEOWNERSHIP EDUCATION AND COUNSELING 12 (Amy Christian ed., 2005), http://www.nw.org/Network/pubs /studies/documents/MeasuringtheDeliveryCostsofHBE.pdf (finding that some forms of housing counseling had measurable impacts on reducing mortgage delinquency, after controlling for variety of factors); VALENTINA HARTARSKA ET AL., CREDIT COUNSELING AND THE INCIDENCE OF DEFAULT ON HOUSING LOANS BY LOW-INCOME HOUSEHOLDS 3, 39–41 (2002), http://aede.osu.edu/programs/ruralfinance/PDF%20Docs/Publications%20List/Papers /02P03.pdf (discussing effectiveness of credit counseling programs).

104. Eric S. Belsky et al., *Consumer and Mortgage Credit at the Crossroads*, *in* BORROWING TO LIVE: CONSUMER AND MORTGAGE CREDIT REVISITED 5, 54 (Nicolas P. Retsinas & Eric S. Belsky eds., 2008). In his article, Belsky refers to a survey conducted by Princeton Survey Research Associates International, which found that roughly one-third of the respondents said that they had received professional advice of some kind regarding procuring a home loan or dealing with a delinquent home loan. *Id*. The Housing and Economic Recovery Act of 2008, among other things, provided additional funds for housing counseling. Pub. L. No. 110-289, § 1132, 122 Stat. 2654. The Mortgage Reform and Anti-Predatory Lending Act would provide further funding and create an Office of Housing Counseling. Title IV, H.R. 1728, 111th Cong. (2009).

105. DEANNE LOONIN & TRAVIS PLUNKETT, NAT'L CONSUMER LAW CTR. & CONSUMER FED'N OF AM., CREDIT COUNSELING IN CRISIS: THE IMPACT ON CONSUMERS OF FUNDING CUTS, HIGHER FEES AND AGGRESSIVE NEW MARKET ENTRANTS 6, 9 (2003), http://www.consumerlaw.org/initiatives/credit_counseling/content/creditcounselingreport.pdf.

106. *Id*. at 8–9. Many credit counseling and housing counseling agencies are established as nonprofit entities and receive funding from the creditors who benefit from the debt-management plans and other payments that counselors funnel to these funders. *Id*.

107. *Id*. at 9, 26.

A typical strategy followed by these credit counselors would be to encourage debtors with high credit card debt and home equity to refinance their mortgages or take out second mortgages to "arbitrage" the difference between secured and unsecured credit.[108] By reducing their interest rates, homeowners with unsustainable levels of unsecured debt were frequently able to reduce their payments and return to a—for the moment—sustainable debt load. This strategy is a double-edged sword. While the refinancing solves the problem in the short term, these counselors may not have focused on the underlying problem: that the family was living beyond its means. The refinancing may only have delayed the inevitable, converting a homeowner with dischargeable unsecured debt and exempt home equity into a debtor whose home is at risk.

There is some limited data to suggest that voluntary credit counseling helps consumers in concrete ways.[109] Mandatory credit counseling may or may not provide the same benefits, however. Mandatory prebankruptcy counseling clearly happens at a time when it is too late to help.[110] Mandatory housing counseling before entering into a nontraditional mortgage, such as a reverse mortgage, or upon exceeding certain financial benchmarks, may provide timely intervention, or it too may be too late, as the prospective debtor may already be too far into the process of purchasing a house.[111] At that point it may do nothing more than confuse the borrowers subjected to it.

Some individuals may have access to financial literacy classes that are not one-on-one counseling sessions, and, for a lucky few, these classes are affordable or even free. In theory, financial classes of this sort may provide consumers with the tools they need to translate complex disclosure information into practical information about whether one loan is more affordable than another, whether certain terms are unusually risky, and so on. Some data shows that personal financial management instruction assists those who attend according to several measures,[112] but many question the effectiveness of these initiatives.[113] Increasingly, these sorts of classes are being offered in high schools, workplaces,

108. *Id.* at 25.

109. Belsky, *supra* note 104, at 54; Hirad & Zorn, *supra* note 103, at 155-57. *See generally* Gregory Elliehausen et al., *The Impact of Credit Counseling on Subsequent Borrower Behavior*, 41 J. CONSUMER AFF. 1 (2007).

110. *See* Jean Braucher, *An Empirical Study of Debtor Education in Bankruptcy: Impact on Chapter 13 Completion Not Shown*, 9 AM. BANKR. INST. L. REV. 557, 565–66 (2001) (finding that those who enroll in debtor education in bankruptcy wish they could have received personal financial education at earlier age, preferably in high school and at home).

111. See Donna S. Harkness, *Predatory Lending Prevention Project: Prescribing a Cure for the Home Equity Loss Ailing the Elderly*, 10 B.U. PUB. INT. L.J. 1, 44 (2000), for a discussion of the necessity of mandatory housing counseling in advance of reverse mortgages.

112. *See, e.g.*, Richard L. Wiener et al., *Debtor Education, Financial Literacy, and Pending Bankruptcy Legislation*, 23 BEHAV. SCI. & L. 347, 364 (2005) (finding that debtors who underwent financial management training were less disposed to making unnecessary purchases and credit card purchases than debtors who did not receive any training).

113. *See* Braucher, *supra* note 110, at 590–91 (concluding that more studies ought to be done to fully assess impact of debtor education in bankruptcy). *See generally* Lauren E. Willis, *Against Financial-Literacy Education*, 94 IOWA L. REV. 197 (2008).

community centers, and other locations. But all too often this sort of personal financial management instruction is unavailable, provided or financed by interested actors, or available too late—after an individual has filed for bankruptcy.

4. Lender Disclosure Requirements

Federal laws, such as the Truth in Lending Act ("TILA")[114] and the Home Ownership Equity Protection Act ("HOEPA"),[115] require enhanced disclosure of the terms of a mortgage loan. TILA requires lenders and other suppliers of mortgage credit to disclose fully, fairly, and conspicuously the terms on which home loans are being offered.[116] HOEPA imposes enhanced disclosure standards on higher-priced mortgage loans.[117] The Federal Reserve Board has jurisdiction to implement TILA and HOEPA and has done so through Reg Z and Reg C, both of which it amended recently to prohibit certain acts and practices relating to closed-end mortgage loans, including higher-priced mortgage loans.[118]

Disclosure requirements are an essential component of a reformed market for home mortgages. However, HOEPA's enhanced disclosure requirements associated with higher-priced loans have been too easily evaded,[119] and more importantly, neither HOEPA nor TILA take proper account of consumers' cognitive limitations or the heuristic biases that may infect consumer consumption and borrowing decisions.[120]

114. Truth in Lending Act, Pub. L. No. 90-321, 82 Stat. 146 (1968) (codified at 15 U.S.C. § 1601 (2006)).

115. Home Ownership and Equity Protection Act of 1994, Pub. L. No. 103-325, 108 Stat. 2190 (codified at 15 U.S.C. § 1602).

116. 15 U.S.C. § 1631. See generally LACKO & PAPPALARDO, IMPROVING CONSUMER MORTGAGE DISCLOSURES, *supra* note 41, at 1–7, for a more detailed discussion of the disclosure requirements.

117. "Higher-priced mortgage loans" are currently defined as "closed-end" consumer credit transactions "secured by [the] consumer's principal dwelling" where the annual percentage rate (APR) on the loan exceeds the average offer rate on prime loans published by the Board "by at least 1.5 percentage points for first-lien loans, or 3.5 percentage points for subordinate-lien loans." Truth in Lending, 73 Fed. Reg. 44522–44523 (July 30, 2008) (codified at 12 C.F.R. pt. 226) [hereinafter Final HOEPA Rules]. Before the 2008 amendments to Reg Z, higher-priced mortgage loans generally were defined as loans where the APR exceeded the yield on Treasury securities of comparable maturity by more than eight percentage points for first-lien loans or ten percentage points for subordinate lien loans. Some states also regulate "high-cost loans" but define this term more broadly than the federal regulation. *See* Final HOEPA Rules, *supra* (defining high-cost loans). In an attempt to guard against predatory home loans, Fannie and its lender partners announced that they would not purchase mortgages that violated either HOEPA or certain of these state regulations. Pamela S. Johnson, *Fannie Mae Guides on Purchase of New Jersey and New Mexico "High-Cost Home Loans," and Illinois "High-Risk Home Loans*," 58 CONSUMER FIN. L.Q. REP. 173, 173 (2004).

118. *See generally* Final HOEPA Rules, *supra* note 117.

119. *See* IMMERGLUCK, *supra* note 1, at 168–69 (stating that HOEPA may have encouraged growth of subprime market, instead of restraining subprime lending).

120. *See generally* Susan Block-Lieb et al., *Disclosure as an Imperfect Means for Addressing Overindebtedness: An Empirical Assessment of Comparative Approaches*, *in* CONSUMER CREDIT, OVER-INDEBTEDNESS AND BANKRUPTCY: NATIONAL AND INTERNATIONAL DIMENSIONS (William Whitford et al. eds., 2009).

- First, there is substantial evidence that consumers have difficulty comparing financial products, even when the terms are clearly disclosed.[121] While consumers can easily compare the cost of two thirty-year, fixed-rate mortgages, it may be very difficult for many consumers to compare a thirty-year fixed mortgage to a 7/23 balloon, or an ARM that resets after two years. Even if the terms are fully disclosed, how many consumers will understand what LIBOR +2 means, or even whether it is a good or bad rate? As such, the proliferation of mortgage products undercuts the effectiveness of disclosure because of the possibility of cognitive overload.[122]
- Second, in addition to cognitive limitations, borrowers are subject to a number of predictable decision-making biases. As noted above, these include optimism bias (overestimating future income and underestimating the probability of future income shocks or extraordinary expenses)[123] and hyperbolic discounting (extreme discounting of future payments).[124] In addition, borrowers may be particularly susceptible to "expert advice" received from brokers and originators as to the wisdom of the terms on which mortgage financing has been offered.[125]
- A third problem with disclosure created by heuristic bias is one of timing and endowment effects. Under TILA and Reg Z, the lender must make certain disclosures about the home loan. However, those disclosures are generally made at or just before the closing on a home purchase transaction.[126] At this point, there is substantial momentum behind the transaction. The buyer has already found a house, chosen a mortgage, and invested substantial sums in due diligence. Backing out at that point may not be a practical solution, so the disclosures are highly unlikely to protect the consumer from improvident decisions. In the consumer's mind, the house is already purchased, and the loan is already incurred. The signing of documents is merely a formality. Psychologically, it is too late to back out. Indeed, this may not be just a psychological point. To the extent that money has been spent, sunk costs and possible contractual liability limit the ability of a home purchaser to back out if the TILA disclosures give them pause. While the Mortgage Disclosure

121. Elizabeth Renuart & Diane E. Thompson, *The Truth, the Whole Truth, and Nothing but the Truth: Fulfilling the Promise of Truth in Lending*, 25 YALE J. ON REG. 181, 193–94 (2008). *See generally* Susan Block-Lieb, *Mandatory Protections as Veiled Punishments: Debtor Education in H.R. 975, the Bankruptcy Abuse and Consumer Protection Act of 2003,* 69 BROOK. L. REV. 425 (2004).

122. See Renuart & Thompson, *supra* note 121, at 186–245, for a discussion of the many problems associated with TILA-required disclosure, including disclosure of APR, finance charges, and other information in the market for home loans.

123. See *supra* Part II.B.2.iii for a discussion of optimism bias.

124. See *supra* Part II.B.2.ii for a discussion of hyperbolic discounting.

125. See *supra* Part II.B.2.iv for a discussion of borrowers' reliance on "expert advice."

126. Truth in Lending Act, 15 U.S.C. § 1604 (2006); Truth in Lending, 73 Fed. Reg. 44522, 44542 (July 30, 2008) (codified at 12 C.F.R. pt. 226). The timing of disclosure for closed-end mortgages was enhanced by the Mortgage Disclosure Improvement Act of 2008 ("MDIA"). Pub. L. No. 110-289, 122 Stat. 2855 (2008). Revisions to Regulation Z to implement MDIA subsequently were adopted by the Federal Reserve Board. Truth in Lending, 74 Fed. Reg. 23289 (May 19, 2009) (codified at 12 C.F.R. pt. 226).

> Improvement Act of 2008 now requires earlier and more extensive disclosure in this context, it only applies to loan applications received after July 30, 2009.

Disclosure regulation proceeds from the assumption that transparency is sufficient. However, transparency may not be enough. Consumers may affirmatively need help in comparing the costs and risks of complex products, and regulation may even need to take into account heuristic biases in fashioning disclosure.

5. Restrictions on Lender Behavior

Regulation need not stop at notice, however, and it may be that regulations may regulate certain types of lender behavior. This regulation can be procedural or substantive, regulating the bargaining process or the specific terms of loans.

(i) Cooling-Off Periods

One promising procedural technique is the cooling-off period. These provisions make certain transactions nonbinding for a specified period so that the consumer can obtain advice about the transaction and think more fully about its financial and welfare implications. But consumers need to be aware of these cooling-off periods for them to work, and even then, they do not provide consumers with the skills they need to assess the data provided. HOEPA provides three-year-long cooling-off periods where lenders transgress its disclosure requirements. These lengthy cooling-off periods masquerade as conditional invalidations of the worst predatory home loans, but because the conditions associated with triggering these lengthy cooling-off periods are complicated, they limit the effect of invalidation to those subprime borrowers lucky enough to seek legal counsel within the requisite three-year period (or unlucky enough, since frequently the triggering event is foreclosure).

(ii) Product Regulation

An even more aggressive response to consumer cognitive limitations and heuristic biases would be to affirmatively limit the types of products that could be offered to consumers. An extreme example of such restrictions would be usury limits on home loans. This would operate metaphorically as a type of "true" gatekeeper, because it would limit the ability of lenders to engage in risk-based pricing with regard to certain risky borrowers, at least on a state-by-state basis. But Congress eliminated this possibility with the enactment of the Depository Institutions Deregulation and Monetary Control Act of 1980 ("DIDMCA").[127] DIDMCA, with limited exceptions, eliminated state mortgage usury ceilings and other restrictions on discount points, finance charges, and other charges applied to residential mortgages on real property and mobile homes, provided these home loans complied with consumer protection regulations promulgated by the Federal Home Loan

127. Depository Institutions Deregulation and Monetary Control Act of 1980, Pub. L. No. 96-221, 94 Stat. 162 (codified as amended in scattered sections of 12 U.S.C., 15 U.S.C.).

Bank Board (or its successor agencies).[128] The Federal Home Loan Bank Board has been succeeded by the Office of Thrift Supervision ("OTS"). OTS is infamous as the paradigm of an agency subject to industry capture;[129] putting OTS in charge of consumer protection regulations has been something like putting the fox in charge of the henhouse, after vesting the fox with *Chevron* deference.[130]

Less constraining behavioral restrictions take into account consumer biases without limiting consumer autonomy. One set of behavioral restrictions might address the cognitive limitations of borrowers, not by restricting interest rates, but by limiting the number of forms available to consumers. This is already, as a practical matter, true in the "prime" market, as mortgages exist only in certain standardized forms to ensure that they can be packaged with other similar mortgages. In particular, mortgages could be required to have level amortization; teaser rates could be prohibited. Similarly, while it might be too much to require all mortgages to be thirty-year, fixed-rate instruments, five- or ten-year locked-in rates might be required. This would address both the comparison problem, by limiting the number of products for consumers to compare, and problems created by consumers' heuristic biases, by preventing lenders from back loading the cost of the loan in an effort to hide it from the consumer. But regulations like these don't exist under current law.

Based on the Fed's jurisdiction to prohibit acts and practices that it finds unfair, deceptive, or designed to evade the provisions of HOEPA, it recently promulgated revisions to Reg Z and Reg C.[131] Many of these revisions go beyond merely requiring enhanced disclosure regarding higher-priced mortgage loans. In addition to adjusting the definition of higher-priced mortgage loans,[132] the revisions prohibit creditors from extending a higher-priced loan based solely on the value of the dwelling and without regard to the borrower's ability to repay, or without verification of the borrower's income and assets. The revisions also prohibit creditors from extending higher-priced mortgages with prepayment penalties if the payment can change in the first four years of the loan's term and restrict prepayment penalties in other covered mortgages to the first two years of

128. 94 Stat. at 162. In 1989 the Federal Home Loan Bank Board ("FHLBB") was abolished. Financial Institutions Reform, Recovery, and Enforcement Act of 1989, Pub. L. 101-73, 103 Stat. 183, 354. The FHLBB was replaced by the Federal Housing Finance Board ("FHFB") and the Office of Thrift Supervision ("OTS"). *Id.* The FHFB ceased to exist on July 20, 2009, when it was replaced by the Federal Housing and Finance Agency ("FHFA"). Housing and Economic Recovery Act of 2008, Pub. L. 110-289, § 1311, 122 Stat. 2654, 2797.

129. *See generally* John Poirier, *U.S. OTS Expects End of Treasury IG Probe*, REUTERS, Apr. 29, 2009, http://www.reuters.com/article/idUSTRE53S6SO20090429.

130. *See* Michael Herz, *Deference Running Riot: Separating Interpretation and Lawmaking Under* Chevron, 6 ADMIN. L.J. AM. U. 187, 194 (1992) (noting that *Chevron* prohibits judicial meddling with agency's implementation of its delegated authority to fill in any gaps left by Congress in interpreting statutes); Nicholas S. Zeppos, *Department of Justice Litigation: Externalizing Costs and Searching for Subsidies*, 61 LAW & CONTEMP. PROBS., Spring 1998, at 171, 189 (observing that where "agency knows that it is an infrequent litigant it may have no incentive to earn goodwill"). *See generally* Chevron v. Natural Res. Def. Council, Inc., 467 U.S. 837, 865 (1984).

131. Final HOEPA Rules, *supra* note 117.

132. See *supra* note 117 and accompanying text for current and past definitions of "higher-priced mortgage loans."

the loan's term.[133] They also require covered mortgages to establish an escrow account for property taxes and homeowners' insurance.[134] The revisions prohibit creditors or mortgage brokers from coercing, influencing or encouraging appraisers to misrepresent the value of a borrower's principal dwelling, and prohibit mortgage brokers from directly or indirectly receiving compensation unless the mortgage broker and the borrower entered into a written agreement specifying the total dollar amount of the broker's compensation.[135] Finally, they prohibit specified servicing and advertising practices as related to higher-priced mortgages.[136] Whether these revisions will affect future markets for home loans, especially subprime mortgages, remains to be seen. But, of course, the revisions apply only prospectively and so might justifiably be viewed as "too little, too late."

6. In Sum

In theory, demand-side gatekeepers might assist individual borrowers in their decisions to incur mortgage debt. Lawyers or brokers are often involved in these transactions, sometimes even as borrowers' fiduciaries. Others have financial interests in guarding against consumers' improvident borrowing, such as co-op boards and community organizations. Yet others offer themselves as counselors, instructors, and advisors to borrowers in the market for home loans. In practice, however, these institutions provide little if any safeguard against debtors incurring unsustainable levels of debt.

If supply-side gatekeepers suffer from conflicts of interest, and demand-side gatekeepers cannot provide the sort of advice that consumers would need in order to counteract misaligned incentives in the supply for home loans, can regulation be relied upon to resolve these conflicts?

IV. CONCLUSION—WHO CAN DEBIAS THE CONSUMER?

Our review of demand-side institutions for protecting consumers leaves us with the conviction that the only participants in the transaction with an interest and understanding of the sustainability of the mortgage and the borrowers' default risks are the lenders themselves. While mortgage brokers may not have consumers' interests at heart, and imperfections in the supply side create the potential for conflicts of interest, they might still be relied upon to react to business incentives. They still may be the least-cost avoider of harm to consumers, if their incentives can be properly calibrated. As such, the form that consumer protection regulation may have to take going forward may be in the regulation of the behavior of lenders themselves. This regulation may take the form of duties to the consumer, such as requiring the lender to police the sustainability or appropriateness of the loan itself.

133. Final HOEPA Rules, *supra* note 117.

134. *Id.*

135. *Id.*

136. *Id.*

The problem with placing such a burden on the lender is that it may unduly chill the market for loans, by making lenders gun-shy in the face of possible liability. To deal with this problem, the duty placed on lenders must be well defined, and, while meaningful, capable of routinization. It is likely that some form of public institution, such as an agency or group of agencies, would need to formulate a series of prohibited and mandated practices, as well as use behavioral insights to determine which forms of loans and loan terms hold particular danger for consumers.

In future work we hope to flesh out the shape that such regulation would take. In our view, this regulation must take account of the following concerns:

- A duty on lenders not to sell inappropriate loan products to consumers
- A definition of appropriateness that incorporates
    - The borrower's income
    - The borrower's expenses
    - The variability of the borrower's income and expenses
    - The other major expenses that the borrower is likely to face
    - The risk attributes of the loan product
    - The transparency of the loan product's terms
- Regulation or prohibition of terms that are likely to be calculated to capitalize on predictable heuristic biases and predictable shifts in preferences
- An institution or institutions that can approve standard forms for loan products
- An overarching architecture that considers both the biases of consumers and the exigencies of mortgage financing

In short, a comprehensive architecture for regulating home mortgages must take into account both the informational needs of the supply side and the predictable weaknesses of consumers.